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Auditor Liability "Caps"– The Politics of Catastrophe

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What a year it's been: prominent Wall Street firms have collapsed and disappeared, almost overnight; one of the world's biggest insurance companies has been effectively "nationalized"; the federal government has engaged in serial bailouts of financial troubled institutions; and Capitol Hill has called for tough new regulatory oversight on the entire financial services industry.

In this volatile and changing landscape, pending proposals for litigation reform have received scant attention from U.S. regulators in recent months, as the more pressing business of the "credit crunch" has commanded the attention of most business and political institutions.[1] Yet with the widening crisis, the need for litigation reform has become more evident that ever. This paper examines one area of litigation reform that warrants more immediate attention: the proposals for liability "caps" for accounting firms, and other ideas for mitigating the risk of catastrophic liability to the Big Four accounting firms.

The Policy Debate Over Catastrophic Risks to Audit Firms

Much has been written concerning the global threat of meritless litigation against the Big Four accounting and auditing firms—Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers. As has been pointed out in countless white papers, articles, and speeches, while the sheer numbers of securities class action suits filed against major accounting firms in the last few years has not been large, the risk of catastrophic liability in any one of those cases is enormous. The example of Arthur Andersen's demise following the collapse of Enron Corp. still serves as an object lesson to all that a single exposure can lead to the ruin of any one firm.

Unfortunately, the politics of catastrophe have led some politicians and regulators to say that the risks to major accounting firms are overblown, or perhaps even fictitious.

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Like the current political debate about the Treasury's Troubled Asset Relief Program (TARP), there are some who would argue that government should not intervene to save a firm whose own conduct is alleged to have led to its dire financial condition. Still others—conservatives of a different sort—are content to let market forces determine which firms shall live, and which shall die.

Advocates of liability reforms for the accounting profession counter these arguments with their own market-based appeals, to the effect that U.S. and global issuers would be adversely affected by the loss of one of the Big Four firms, a situation that invariably would leave too few qualified independent auditors to serve the needs of the public company community. According to these advocates, the barriers to entry for other firms who might seek to join the ranks of the Big Four are considerable, and the time period and resources it would take for another major firm to emerge and compete effectively with the Big Four represent significant, if not insurmountable, obstacles to creating alternatives to the current regime. Given this stark reality, these advocates argue, the populist need to "punish" accounting firms involved in financial frauds must be balanced against the realistic needs of the capital markets.

Adding to this charged policy debate is the fact that audit firms, unlike other market participants who are sued in securities class actions, are viewed by regulators as important "gatekeepers" who have unique duties and obligations to be vigilant sentries against management fraud. In the view of some opponents of liability caps, giving any safe harbor to audit firms would erode this gate-keeping function, and reduce the economic incentives for audit firms to "do the right thing." Thus, the risk of catastrophic exposure is the very glue that holds the audit firm's gatekeeper model together.

What, then, to make of this debate? To some degree, the argument that liability caps for audit firms are inconsistent with their gatekeeper function is difficult to square with the fact that, in other contexts, the law has no hesitation in affording companies, their directors, and their lawyers with various forms of limited liability protections. Thus, directors are traditionally shielded from claims for monetary relief under the "exculpation" statutes of virtually all 50 states. Likewise, under federal law, directors and officers are shielded from liability in making forward-looking statements by the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 (PSLRA). Lawyers also enjoy certain protections against potential liability if they comply with the "reporting up" provisions of the Sarbanes-Oxley Act, Section 307. These and other examples demonstrate that public policy has extended protections to other classes of gatekeepers without significant controversy. Viewed in this light, the arguments against liability protections for audit firms because of their "gatekeeper" role is unsustainable.

Looking at the liability protection scheme for other classes of gatekeepers also helps illuminate how legislators and courts have become comfortable with concepts of limited liability, even in situations of admitted fraud. Under Delaware law, for example, courts routinely dismiss claims against directors accused of making bad decisions, or failing in their oversight duties, so long as the Board is found to have exercised informed business judgment, and has not "utterly failed" to implement and oversee a compliance system.[2] This long-standing rule of law—admittedly focused on *process*—has never been seriously questioned, despite the fact that in countless cases, boards of directors have been alleged to have mismanaged the companies on whose boards they sat, and engaged in acts of corporate waste. Given this legal largesse for corporate insiders, it is hard to justify the proposition that audit firms—the proverbial "outsiders"—should be subjected to harsher punishments and denied any procedural protections against the risk of catastrophic liability. One must ask why the "business judgment rule" fully protects directors and officers, but audit firms who invoke similar procedural arguments—compliance with Generally Accepted Auditing Standards (GAAP)—have no protections at all.

Are there other possible solutions than liability caps? Let's try this one—"nationalize" the audit function, and eliminate the entire concept of privatized gatekeepers. Under that model, one at least would eliminate the argument often voiced by class action plaintiffs' lawyers that audit firms

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are motivated to look the other way because of the substantial audit fees they earn. But would anyone seriously think that government auditors would do a better job at making complex accounting judgments than their "privatized" counterparts?

Liability caps make sense if one appreciates that the basic job of the outside auditor is to review and pass on a multitude of discrete accounting judgments rendered by management, based on audit procedures performed in a time-limited fashion, involving a dynamic business environment that is constantly shifting over time. Understood this way, auditor decision-making arguably shares some similar attributes to that of outside directors under the business judgment rule, where the courts assume that boards of directors will not always make the right decisions—and that they should be protected against monetary claims if they at least make "informed" decisions.

Specific Reform Proposals

Following is an overview of some of the key reform proposals relating to the audit profession, both in the U.S. and abroad.

U.S. Reform Proposals Directed to Protection of the Accounting Profession

The "Paulson Committee" Report—The history of the "Paulson Committee" begins in November 2006, with the release of a preliminary report by the Committee on Capital Markets Regulation. The Committee, led by Hal Scott, a Harvard law professor, Glenn Hubbard, the dean of Columbia's business school, and John L. Thornton, a former president of Goldman Sachs and current chairman of the Brookings Institution, is colloquially referred to as the "Paulson Committee" because it was created with the imprimatur of U.S. Treasury Secretary Henry Paulson. The Committee issued its "Interim Report of the Committee on Capital Markets Regulation" in order to address various challenges facing the U.S. capital markets, and to propose regulatory and market reforms directed to those challenges. The Committee's Interim Report concluded that the competitiveness of U.S. capital markets was declining, a development the committee attributed in part to the comparatively high costs of U.S. regulatory compliance and litigation risk. Among other things, the committee recommended that Congress explore options for protecting auditors from catastrophic liability.[3]

The Interim Report discussed the increasing liability risks posed to the remaining Big Four accounting firms, and the possible impairment of consumer choice if one of those firms were to fail. The Report noted in particular that there are more than three dozen cases involving tens of billions of dollars of potential exposure to accounting firms, and expressed the concern that even a relatively small share of proportional liability in these cases may lead to the financial failure of one of the remaining firms. "For the profession itself, there is consensus both inside and out that the demise of one of the remaining Big Four could have adverse consequences for audited companies and their shareholders,"[4] the report stated.

In light of these concerns, the Interim Report included several proposed reforms addressing the issue of auditor liability:

- Create a safe harbor for certain defined auditing practices;
- Set a cap on auditor liability in certain circumstances;
- Grant regulators specific powers to appoint "monitors" to oversee operations of audit firms found to have engaged in systemic failures in process, management or personnel;
- Clarify and limit an auditor's duties under Section 10A; and
- Restrict criminal indictments against firms, as opposed to individual audit partners.

Following release of the Interim Report, the U.S. Treasury Department announced on May 17, 2007 that it was appointing a "Treasury Advisory Committee on the Auditing Profession," headed up Arthur Levitt, former Chairman of the Securities and Exchange Commission (SEC) and former SEC Chief Accountant Donald Nicolaisen, to

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consider possible reforms relating to the accounting profession.

In January 2008, the Advisory Committee released a Draft Decision Memo. With respect to auditor liability, the Draft Decision Memo outlined the concept of a "framework for professional judgment in accounting," pursuant to which auditors' work could be evaluated against the guidelines, and a limited "safe harbor" would be available to auditors whose exercise of professional judgment is the outcome of a process in which each involved person has the "appropriate level of knowledge, experience, and objectivity" to form an opinion on the subject. To that extent, the "framework" sounds somewhat like the Delaware "business judgment rule" that serves to protect directors against personal liability in the exercise of business judgment.

In May, the Advisory Committee released a draft report. Noticeably absent from the May draft report was any specific recommendation concerning liability reforms for audit firms, or the "framework" discussed in the January Draft Decision. In its place, the Advisory Committee offered ideas for more standards-setting and disclosure concerning the auditor's duty to detect fraud, more transparency in company disclosures concerning a change in auditors, and more mechanisms to monitor potential catastrophic risks faced by public company audit firms, including "rehabilitation" procedures for troubled audit firms, and "key indicators" of audit quality and effectiveness.

On June 3, the Advisory Committee issued an Addendum, not voted upon by the full committee, but nevertheless proposing significant new ideas for addressing auditor liability issues. Specifically, the Addendum indicated that the Committee "is considering whether it should recommend that Congress provide federal courts with exclusive jurisdiction over some categories of claims" against auditors, and if so whether Congress should enact a "uniform standard of care." The Committee announced that it was seeking input on three questions: 1) whether it is appropriate to have exclusive jurisdiction for some categories of claims and a uniform standard of care; and if so, 2) what types of claims should be subject to federal jurisdiction; and 3) what should be the standard of care.

On Sept. 26, the Advisory Committee released a draft of its final report. The report succinctly stated that "no audit firm is too big to fail," and that any such failure would have "systemic repercussions throughout the global capital markets." Nevertheless, the Committee could not reach a consensus recommendation on private litigation. The Committee acknowledged, however, that it is "desirable to continue that debate," and that "policy makers and the legal system should consider progressively moving towards a structure that at least for the most part embodies a common national set of standards," and perhaps a "national professional liability regime for public company auditing firms." The Committee also observed that "Congress may in fact wish to consider creation of a federally chartered audit structure for firms which choose to operate as such." Within such a structure, the Committee states, one characteristic might be "limits of liability for audits of public companies."

Not surprisingly, after almost two years of work, the Paulson Committee's "non-recommendations" were not satisfying to some of the participants in that effort. Former SEC Chief Accountant Lynn Turner, who was the sole dissenter on the Committee's 14-1 vote to approve the final report, was more vocal, saying that it might have been better for the audit profession if the Committee had simply left the issue of catastrophic liability unaddressed in the final report. "Right now, I don't see any chance whatsoever of any litigation reform in light of what happened with this group," Turner is quoted as saying.[5] The head of the Center for Audit Quality, Cynthia Fornelli, who had strongly advocated that the Committee should address the issue of catastrophic liability "comprehensively," was more hopeful, saying that "we encourage those in the policymaking community to use this report's acknowledgement of catastrophic liability as a starting point for further examination of the issue."[6]

Other U.S. Reform Proposals

The Bloomberg-Schumer Report—In early 2007, New York City Mayor Michael R. Bloomberg and

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Senator Charles E. Schumer (D-N.Y.) issued a comprehensive report entitled "Sustaining New York's and the US' Global Financial Services Leadership." The Bloomberg-Schumer Report made a number of recommendations to increase the competitiveness of the U.S. capital markets, a few of which are pertinent to the protection of audit firms, echoing the Paulson Committee report. Specifically, the Bloomberg-Schumer report proposed imposition of a "cap" on auditor damages that would maintain the deterrent effect of large financial penalties, while also reducing the likelihood of the highly concentrated US auditing industry losing another major player.

Commission on Regulation of the U.S. Capital Markets in the 21st Century—A March 2007 report from the Commission on the Regulation of U.S. Capital Markets in the 21st Century recommended several broad litigation reforms, and specifically called upon the SEC to undertake a thorough review of how the PSLRA has addressed the problem of frivolous shareholder litigation since its passage by Congress.

This Commission recommended that domestic and international policy makers "seriously consider proposals … to address the significant risks faced by the public audit profession from catastrophic litigation." Among other findings, the report stated that "sustaining a strong, economically viable, public company audit profession is vital to domestic and global capital markets," and that this condition is threatened by the current climate of civil litigation and regulatory proceedings against accounting firms.[7] Specific recommendations of the Commission included:

- Focus any criminal indictments on culpable individuals within audit firms, not the firms themselves;
- Create a national charter, similar to the national bank charter, that would confer positive benefits for audit firms by replacing the multiplicity of conflicting state regulations now facing audit firms;
- Include international audit firm liability issues as a topic to be addressed by the Group of Eight (G-8) countries;
- Expand the overall capacity of the audit profession through expansion of the next tier of audit firms below the Big Four; and
- Strengthen the ability of audit firms to use arbitration or other Alternative Dispute Resolution (ADR) solutions instead of litigation in the court system.

European Commission Proposals for Protection of the Audit Profession

The concept of liability "caps" is being actively promoted by the European Commission as a means of avoiding the failure of any of the major audit firms practicing in the European Union. The specific ideas that have been reviewed by the European Commission in the last few years include:

- Fixed monetary caps at the European level;
- Caps based on market capitalization of the audited company;
- Caps based upon a multiple of audit fees; and
- Proportionate liability based upon degree of responsibility.

Early in 2007, Charles McGreevy, an EU Internal Market commissioner, voiced support for these ideas: "there is a real danger of one of the Big Four being faced with a claim that could threaten its existence," he said.[8] The European Commission established an "Auditors Liability Forum" to consider the issues, comprised of representatives from the Big Four firms, as well as other constituencies. In January 2007, the European Commission issued a Staff Working Paper on "Auditors Liability and Its Impact on the European Capital Markets," in which it noted an array of potentially adverse consequences if another Big Four audit firm were to fail, and also the challenges to attracting new audit firms to step forward. The Commission's Working Paper was largely based upon an independent study by London Economics.[9] In a January 2008 talk, McGreevy was quoted as saying that "I do not intend to impose the means by which liability is limited."[10]

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In June, the European Commission came out with a proposal to limit liability awards against accounting firms where the civil claims arise out of audit work for listed companies. Among other details of the proposal, the limited liability scheme *would not* apply if there was intentional misconduct by an auditor. The EU said that this proposal would encourage new entrants into the field, especially for smaller audit firms.

Almost immediately, the European Commission's proposal was met with criticism from certain quarters, including the European lobbying group representing the insurance and reinsurance industries. And in August, the International Corporate Governance Network (ICGN) attacked the European Commission's efforts to allow EU member states to impose auditor liability limits, arguing that the proposal would favor auditors "to the detriment of other stakeholders and especially shareholders." These negative commentaries were countered by positive praise from other organizations, such as the Federation of European Accountants (FEA).

At press time, the prognosis for adoption of the European Commission's proposals by any of the member states is not clear. But conceivably, the first significant victory in the battle over liability "caps" will be in Europe, a win that will set an important precedent for possible similar protections in the United States.

Conclusion

Despite the many constructive proposals that have been generated over the last few years to address the issue of catastrophic liability for accounting firms, no clear consensus has yet to develop in the United States. In Europe, the recent proposals by the European Commission suggest that limited liability protections for audit firms may become reality soon. The importance of solving this issue cannot be understated, and the dialogue over these proposed reforms must continue.

NOTES

1. For background on the many recent securities litigation reform proposals, see Dickey, *2008 Securities Litigation Reform Forecast: Cloudy, Chance of Rain*, *Securities Litigation Report*; February 2008 (vol. 5, no. 2) © Thomson West Legalworks.
2. *See, e.g., Stone ex rel. AmSouth Bancorporation v. Ritter,* 911 A.2d 362 (Del. 2006); *Wood v. Baum*, 953 A.2d 136 (Del. 2008); *Rales v. Blasband*, 634 A.2d 927, Fed. Sec. L. Rep. (CCH) P 98821 (Del. 1993); *In re Caremark Intern. Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).
3. Interim Report of the Committee on Capital Markets Regulation, Nov. 30, 2006.
4. Interim Report of the Committee on Capital Markets Regulation, p. 87.
5. Treasury Committee's Report Missed Huge Opportunity for Litigation Reform (BNA Corporate Accountability Report, October 31, 2008).
6. Treasury Committee's Report Punts on Auditor Liability Issue, supra.
7. Commission of the Regulation of U.S. Capital Markets in the 21st Century: Report and Recommendations (March 2007), available on the Commission website at www.CapitalMarketsCommission.com.
8. EU Calls for Input on Auditor Liability Caps, (Compliance Week, Feb. 6, 2007).
9. EU Call for Opinions on Auditor Liability Caps (Compliance Week, April 2007).
10. EU Commission to Offer Recommendations on Countries' Liability Caps for Audit Firms (BNA Corporate Accountability, Jan. 4, 2008).

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