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Effect of litigation on independent auditors : a research study

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The Effect of Litigation on Independent Auditors

By Henry R. Jaenicke, CPA, Ph.D.

Commission on Auditors' Responsibilities

Research Study No. 1

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A research study prepared for the Commission on Auditors' Responsibilities

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Foreword

This is the first of four research studies that the Commission on Auditors' Responsibilities will publish in connection with its final report. The studies are not a part of the final report, but the Commission believes that they contain useful material that warrants wide distribution. Publication does not constitute endorsement or approval by either the American Institute of Certified Public Accountants or the Commission. Authors of research studies are responsible for the content and recommendations.

The Commission on Auditors' Responsibilities was appointed in October 1974 to study the role and responsibilities of independent auditors. This study was undertaken to provide background for its discussion of the role that litigation and regulatory enforcement play in the regulation of the profession and for recommendations for changes in the legal environment.

The research study summarizes the current legal environment, analyzes the American Law Institute's proposed *Federal Securities Code*, and discusses the effect of the legal environment on audit practice and on the profession, including the auditing standards, setting function. It concludes with a discussion of various proposals that have been made for changing the legal environment of auditors.

Since the study was particularly helpful to the Commission in reaching several of its conclusions in Section 11 of its final report, "Regulating the Profession to *Maintain the Quality of* Audit Practice," it may enhance understanding of the Commission's conclusions in this area.

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Preface

This monograph was prepared as a background paper for the Commission on Auditors' Responsibilities. Issue III-6 of the commission's *Statement of Issues* is entitled "The Legal Environment of Independent Auditors" and is concerned with the effect of litigation against auditors and the desirability and possibility of changes in that environment. The purpose of the background paper was to assist the commission in its deliberations through a description of the legal climate in which the auditor works, an analysis of its effect on both society and the accounting profession, and descriptions and evaluations of alternative means of changing that climate.

I have had the benefit of the thoughts and suggestions of several individuals. Richard B. Lea of Peat, Marwick, Mitchell & Co. reviewed an early outline of the project. Richard H. Murray, general counsel for Touche Ross & Co., provided useful background on the evolving climate surrounding the profession's insurance coverage. David B. Isbell of Covington & Burling helped me to understand the American Law Institute's Federal Securities Code. Richard Murray, Carl D. Liggio of Arthur Young & Company, Charles B. Hellerson and Matthew Blake of Hurdman and Cranstoun, David S. Ruder of the Northwestern University School of Law, and Alan B. Levenson of Fulbright & Jaworski provided helpful comments on an early draft. All members of the Commission on Auditors' Responsibilities provided both suggestions and support as the project progressed. Thomas W. McRae of the American Institute of CPAs' accounting standards division, and a member of the staff of the Commission on Auditors' Responsibilities, provided substantial assistance on the several drafts of the paper. To those individuals go both generous thanks and the usual absolution from blame for errors and omissions.

Special appreciation must be expressed to the individual who served as my legal counsel on the project, Jeremy L. Wiesen of the Graduate School of Business Administration of New York University. His provocative commentary on content and scholarly assistance on the law significantly enhanced the paper.

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The Litigation Explosion

> The accountant today is living in a litigious environment where he can reasonably expect his every action—regardless of how right or wrong it may be—to be questioned in a court of law and possibly result in substantial damages being awarded against him.[1] [Liggio, 1973, p. 2]

The Extent of Litigation Against Auditors

A 1967 law review article noted that suits "against accountants by persons other than their clients have been almost universally unsuccessful."[2] Three cases in the late 1960s (*Fischer* v. *Kletz*, *Escott* v. *BarChris*, and *United States* v. *Simon*) triggered forces that changed that.[3] By the mid-1970s hundreds of suits were filed against auditors. Estimates of the extent of litigation involving auditors vary, but the following data provide a rough indication.

- In its 1973 annual report Arthur Andersen & Co. estimated that there were 500 companies with litigation or claims in process

1. Complete citations are found in the Bibliography. Citations and footnotes have been omitted from all quotations unless otherwise indicated.
2. *Columbia Law Review*, 67 (December 1967), p. 1437, quoted in Fiflis, 1975a, p. 32.
3. Complete citations to legal cases are found in "Citations to Court Decisions" following the Bibliography. Citations and footnotes have been omitted from quoted court decisions unless otherwise indicated.

involving auditors at March 31, 1973.[4] Presumably, each company represents one "case," and one case may spawn many lawsuits, for example, over 50 in the Equity Funding case (Liggio, 1973, p. 1).

- Liggio estimated that in May 1973 the total number of resolved and pending cases against auditors exceeded 300, of which over 170 had been reported to the profession's largest insurer, Lloyd's of London (Liggio, 1973, p. 1).
- Liggio estimates that by 1974 there were 500 to 1000 pending cases and over 200 decided cases (Liggio, 1974, pp. 18-19).

Cases brought by third parties and related to alleged audit deficiencies may have peaked in 1975 and early 1976, but, even so, the extent of the litigation is awesome, particularly in relation to the almost "zero base" of the mid-1960s.

The extent of litigation can also be measured by malpractice insurance premiums and related costs incurred by auditing firms. Conservative estimates of annual insurance premiums now being paid by the seventeen largest public accounting firms range from thirty to forty million dollars. Adding uninsured losses and loss-deductibles paid by the firms plus a reasonable amount for the costs of developing information within the firms for the defense of cases would probably bring the total to seventy to eighty million dollars.[5] Again, this is a conservative estimate and includes figures for only one segment of the profession.[6]

Scope of the Study

The objectives of this monograph are to describe the legal climate in which the auditor presently works, analyze the effect of that climate on both society and the public accounting profession, and evaluate possible ways of changing that climate.

Several issues are excluded. Settled or pending cases involving auditors are not analyzed to determine deficiencies in audit perform-

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4. The 1974, 1975, and 1976 annual reports do not provide profession-wide estimates.
5. Data developed from nonpublic sources.
6. Various nonpublic sources have estimated that out-of-pocket costs for insurance premiums, unreimbursed litigation losses, and unreimbursed defense fees are in the vicinity of 2 to 3 percent of gross fees of public accounting firms. Arthur Andersen & Co. reported in 1976 "professional indemnity insurance and litigation expense" of $6,351,000, equal to 1.5 percent of total "fees for professional services" of $424,654,-000, or 2 percent of total fees from their domestic practice (reported as 75 percent of worldwide fees). The $6,351,000 represents direct out-of-pocket costs associated with litigation. No precise estimate of personnel costs is possible, but their inclusion would probably not affect the total by more than $500,000.

ance. Legal cases are cited only to identify new or evolving points of law or other changes in the legal environment. Also, suggestions for reducing the auditor's exposure to legal liability are considered only if they would change elements in the legal environment. A higher level of performance would unquestionably reduce exposure, but that issue is not explored. Nor is reduction of exposure by lowering user expectations.[7]

Social Influences on the Legal Environment

Recent developments in common, statutory, and administrative law—technical legal developments—have enhanced plaintiffs' abilities to recover from auditors and, as a result, have led to greatly expanded litigation in recent years. But, as Sommer noted, "these somewhat technical legal developments are not sufficient to explain the explosion of litigation that has confronted accountants during the past ten years. Broad social developments have been the soil in which these seeds have become rooted, and have yielded often bitter fruit" (1972, p. 26). Those social developments and their influence on the legal climate relate to the growth of consumerism, new concepts of insurance, and the increased presence of auditors.

The Growth of Consumerism

Sommer noted that

> First, there has been the emergence of the consumer, so dramatic that it has been suggested we are entering upon the "age of the consumer." The whys of the broad phenomenon are too complex to narrate here, but it is clear that restlessness with the impersonality of technology, political necessities, the emergence of a new brand of populism (Naderism is one form of it), have combined with legal resourcefulness to bring about an equalizing of the position before the law of the consumer and commercial interests (or perhaps a disequilibrium in favor of the consumer). The courts have joined with legislatures to expand the litigation potential of the class suit and develop other means of redress for wrongs which, while existing in the past, because of inertia or legal technicalities were never susceptible of

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7. The level of expectations influences the nature and extent of litigation and regulatory enforcement. Court decisions, SEC actions, and the publicity that results when suits are brought or enforcement proceedings initiated in turn influence user expectations. The level of expectations is clearly relevant to a discussion of the changing legal climate and explains many of the influences on and changes in the legal environment that are discussed in chapters 1 through 5. For a discussion of the importance of defining expectation levels, see Liggio, 1975b, pp. 22-29. The report of the Commission on Auditors' Responsibilities addresses various means of closing the gap between user expectations and auditor performance.

effective redress. Legislatures, state and federal, have tripped over each other providing protection for consumers. . . .

As people have become alert to the possibility of redress in their many roles as consumers, the potentials of the federal scheme of securities regulation have been explored and used. [1972, pp. 26-27]

New Concepts of Insurance

A second influence on the expansion of litigation against the auditor is the increasing awareness of investors and courts that the auditor is an available source of funds for the redress of wrongs. Some auditors contend that investors in publicly held companies seem to look on auditors as performing an insurance function. They suggest several reasons for this phenomenon.

The "Deep Pocket" Theory. Richard H. Murray, General Counsel for Touche Ross & Co., suggested that "whenever a corporation whose stock is publicly traded goes into bankruptcy or experiences a financial reverse, it is tempting for the shareholders and their attorneys to wonder who can be sued for the losses. Obviously, the bankrupt corporation can't pay, so accountants, lawyers, and corporate directors are a tempting alternative deep pocket. With courts inclined to accord investors the favored status of consumers (a difficult similarity to accept) the result is an ever-expanding area of liabilities for the professional advisor."[8] Some slight evidence to support this view may be found in the apparent peaking of litigation by third parties in 1975 or early 1976. One cause of decline in such litigation may be the economic recovery that occurred in 1975 and 1976, although several recent decisions by the Supreme Court also had an effect.

The Auditor as Guarantor. Liggio stated that

the new wave of litigation that has hit the accounting profession clearly proceeds on the assumption that the auditor is the guarantor of the accuracy of a company's financial statements. The plaintiffs and their attorneys simply refuse to acknowledge the judgment-making process that is integral to the auditing function. They also refuse to recognize that management has the primary responsibility for the accuracy of financial statements. [1975a, p. 42]

The "Socialization" of Risks. Rightly or wrongly, auditors are viewed as one segment of society that can act to prevent investor losses and are thus a logical choice to bear those losses. It is also believed by many that auditors can probably shift the cost of providing

8. Letter to the author dated January 22, 1976.

this protection, initially to the client in the form of higher fees and then to society, as those added costs affect product prices and business profits. The investor is thus protected from an otherwise uninsurable risk by the socialization of that risk in a manner consistent with other means of consumer protection without regard to its appropriateness.

The Increased Presence of Auditors

As the public accounting profession has grown in numbers and in stature, it has become better known to the public. The popular press has also discovered the profession and made the public aware of its shortcomings. Factors such as the growth of complex financial transactions, the use of "creative accounting," the growth in the number of investors, and the increased importance of accounting information in the investment process have also contributed to increased public awareness (Sommer, 1972, p. 27).

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Common Law Liability to Third Parties and Clients

Auditors' liability derives from both common and statutory law. Common law evolves from judicial rulings on matters of law in specific cases. Statutory law may codify or change common law. Judicial interpretation of statutory law, in turn, leads to the development of case law precedents (Sommer, 1972, p. 25). This interaction permits the courts continually to define and expand the auditor's role and duties. Sommer was no doubt referring to both kinds of judicially created law when he said,

> If a professional group does not articulate its identity, its duties, the identity of those to whom it owes a duty, and the manner in which the duty is to be acquitted, and if society assigns it a role which, despite its professional standards, it does not fulfill adequately, the courts, vested by society with the responsibility to define and enforce duties, will do it. And that in some measure has been the fate of the accounting profession. [1974, p. 20]

Liability to Third Parties Under Common Law

Until fairly recently, auditors as well as other professionals had been almost immune against successful claims by third parties. That apparent immunity has led to concern by courts and legislatures and resulted in new concepts of auditor liability to third parties. Two important changes are:

- Expansion of the class to whom the auditor owes a duty of care (that is, the required relationship between the plaintiff and the defendant auditor).
- Redefinition of the level of care that the auditor owes to third parties (essentially, the issue of the necessity for intent and the definition of intent) (Fiflis, 1975a, p. 110; Marinelli, 1971, pp. 116-17).

Those issues, as well as some recent developments in the auditor's liability to clients, are discussed in this chapter. Liability to third parties under the federal securities acts is discussed in chapter 3.

Expansion of the Class Under Common Law

The auditor's legal liability *to his client* is grounded primarily in the law of torts, but it may also be based on the contractual relationship between the two parties. In either case, the auditor is required to exercise due professional care, which may be defined as "that degree of care which would ordinarily be exercised by other members of the profession in similar circumstances. In essence, this means adherence to generally accepted auditing standards."[1] A failure to exercise due professional care constitutes (ordinary) negligence ("flagrant or reckless departure from the standards of due care") or fraud ("intentional misstatement or concealment of a material fact") (Willingham and Carmichael, 1975, p. 53).

The client is in a contractual relationship (referred to as privity of contract) with the auditor, and negligence breaches that contract. There is no privity of contract between the auditor and *third parties*. Consequently, claims by third parties (under common law) were traditionally based not on contract law but on a common law tort—a wrongful act that injures another's person, property, or reputation—and only fraud on the part of an accountant, not lack of due care, was considered a wrongful act. "If in rendering his opinion he intentionally deceives third parties for the purpose of inducing them to act in reliance upon his deception, [the auditor] has committed a fraud and he is liable to third parties who can prove that they relied on the information and were damaged thereby" (Willingham and Carmichael, 1975, p. 53).

Ultramares Corp. v. *Touche, Niven & Co.* (1931) extended liability to third parties to instances of professional negligence so gross as to constitute fraud. Gormley analyzed the concept of constructive fraud as follows:

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1. See, however, the discussion in chapter 7.

> Constructive fraud is a deceit which involves a (1) false (2) representation (3) of a material fact (4) with lack of reasonable ground for belief (5) to induce reliance by another (6) relied upon by the other (7) causing (8) damage to him. Actual fraud differs from constructive fraud in knowledge of the falsity of a representation, rather than a lack of reasonable ground for belief in its truth.
>
> Constructive fraud may be inferred from evidence of gross negligence, although negligence is not necessarily constructive fraud in and of itself. Gross negligence is an extreme, flagrant or reckless departure from standards of due care and competence in performing or reporting upon professional engagements. There is no dependable distinction from the oversight, inattention, or error of judgment or perception which amounts only to ordinary negligence. [1974, p. 1207]

Judge (later Justice) Cardozo upheld the doctrine of privity of contract in *Ultramares* as a limitation on the auditor's liability for ordinary negligence, based on a policy decision that all imposed or assumed risks should be determinable.

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in an implication of a duty that exposes to these consequences.

Marinelli asks, however,

> whether the indeterminate nature of this sort of risk in this profession is any more fearsome than the speculative nature of the risks facing any profession. The use of liability insurance among public accounting firms and the ability of the profession to pass the costs of such insurance on to its customers, who in turn can pass on the cost to the entire consuming public, seems to cast doubt on the necessity of the *Ultramares* decision. [1971, p. 119]

This view, however, fails to acknowledge that the potential for loss to the auditor is greater and the amount of loss more indeterminate than for any other profession. A company's financial statements and the accompanying auditor's report may be read by or otherwise influence thousands of investors and creditors with millions of dollars invested. In *Ernst & Ernst* v. *Hochfelder* (1976), the Supreme Court noted that significantly broadening "the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions under the [federal securities] Acts . . . would extend to new frontiers the 'hazards' of rendering expert advice under the Acts, raising serious policy questions not yet addressed by Congress."

Courts and federal statutes have attempted to change, bypass, or otherwise reduce the effects of the privity doctrine to increase the auditor's liability to third parties for ordinary negligence. The first crack in the privity rule occurred in the *Ultramares* case itself with the formulation of the "primary benefit rule." There it was held that "an auditor would be liable to a third party for ordinary negligence if he knew that his audit was being performed for the primary benefit of a third party and that third party was specifically identified" (Willingham and Carmichael, 1975, p. 54).

Gormley suggested, however, that up to ten or so years ago,

> the efforts of third-party plaintiffs to prove that in fact they were primary beneficiaries of a negligent audit were unsuccessful, even in cases such as that in which the auditor knew (1) that his report would be furnished by the client, or was to be furnished by the auditor at the request of the client, to a specific person, and (2) that the report would be used by the client to induce action by that person, such as a loan or investment, and might be relied upon by the person in taking action.
>
> The primary benefit rule may thus have been applied more literally and more broadly than anyone would have expected. The application tended to turn the nonclient primary beneficiary into a theoretical abstraction with little existence in fact. [1974, pp. 1207-08]

Further weakening of the privity-of-contract doctrine in cases of accountants' liability began in 1963, thirty-two years after *Ultramares*, with a series of cases that represented a "frontal assault on the primary benefit rule":

> In 1963, the *Hedley Byrne [Hedley Byrne & Co. Ltd.* v. *Heller & Partners, Ltd.]* case was decided by the highest court of England, the House of Lords. The case did not involve auditors, but rather a negligently stated accommodation credit report by a bank upon which a third person relied to his damage. In their opinions the various justices spoke of "special," "particular," "direct" and "proximate" relationships between defendant and plaintiff, and said in effect that "where there is a relationship equivalent to contract but for the absence of consideration, there is a duty of care." But the justices were not able to generalize their conception of the circumstances which create such a "special relationship." [Gormley, 1974, p. 1208]

The court's finding, however, was intended to have somewhat limited application in that it extended the duty of care to only a restricted class of third parties, as was also the case in *Ultramares*. A statement by the Council of the Institute of Chartered Accountants in England and Wales noted that

> accountants may now be held in law to owe a duty of care to persons other than those with whom they are in a contractual or fiduciary relationship and may be liable for neglect of that duty if, but only if, they know or ought to know that a financial report, account or statement prepared by them has been prepared for a specific purpose or transaction, will be shown to a particular person or class of persons, and may be relied on by that person or class of persons in that particular connection. [1965, p. 67]

The Americal Law Institute (ALI) in its *Second Restatement* of the Law of Torts (1965), partly in reliance on *Hedley Byrne*, interpreted the law of negligent misrepresentations by professionals to third parties more broadly than it had been interpreted in the past (Gormley, 1974, p. 1208). Section 552 of Tentative Draft no. 12 (1966) stated:

> (1) One who, in the course of his business, profession or employment, or in a transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
>
> (2) Except as stated in subsection (3), the liability stated in subsection (1) is limited to loss suffered
> (a) by the person or one of the persons for whose benefit and guidance he intends to supply the information, or knows that the recipient intends to supply it; and
> (b) through reliance upon it in a transaction which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.
>
> (3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created in any of the transactions in which it is intended to protect them.

Gormley summarized the significance of the *Restatement* to auditors:

> The Institute's notes state that its interpretation is intended to exclude liability "to the very large class of persons whom almost any negligently given information may foreseeably reach and influence, and limit the liability, not to a particular plaintiff identified in advance, but to the comparatively small group whom the defendant expects and intends to influence." [Gormley, 1974, p. 1208, citing Tentative Draft no. 11, 1965]

The *Restatement*'s reporter stated that as of 1966 there had been few actual cases that analyzed auditors' liability to a foreseen class of persons for negligence. He further explained that, except for the Securities Act of 1933, the law had not at that time moved so far as to broaden the auditor's negligence liability, where he is "under public duty," to cover a foreseeable class of persons, as was the intent of clause (3) cited above (Chalmers, 1974, p. 79).

The distinction in the *Restatement*'s interpretation of a professional's duty to third parties between *foreseen* and *foreseeable* persons is critical to an understanding of post-1965 legal decisions based on common law. Gormley elaborated on that and related distinctions:

> The commentary and illustrations accompanying the interpretation establish that the interpretation applies in cases in which it is *foreseen* by a professional that his information will be relied upon by a specific person or class

of persons in the specific transaction for which his information is furnished, but not in those in which it is only *foreseeable* to the professional that the dissemination of his information by the recipient will lead to actions in reliance upon it by third persons who become aware of it.

The following is an attempt to classify the factual distinctions, which vary from one extreme to another by infinite gradations of detail:

Primary beneficiary—the identified person whose reliance is the "end and aim of the transaction," who in fact was only the client until after the publication of the Second Restatement.

Foreseen person—one or more specifically identified persons or entities who are known by the auditor to be intended recipients, directly or indirectly, of his audit opinion for the purpose of reliance in a particular business transaction known to the auditor. If the terms are construed literally, the foreseen person includes not only a primary beneficiary, but others as well. A foreseen person includes one who is known to the auditor to be entitled to receive an audit opinion in fulfillment of a condition of closing a business merger or acquisition agreement. It also includes one or more institutional lenders whose loan agreement, to the knowledge of the auditor, requires an audit opinion as a condition of making the loan, and periodic audit opinions and auditor's "compliance letters" for the duration of the loan. Such persons do not appear to fall within the traditional interpretation of a primary beneficiary.

Foreseen class—a particular defined group, any one or more or all of whom may rely upon an audit opinion, specifically identified to the auditor by class, though not known to him individually. According to the Second Restatement, each member of such a foreseen class is entitled to the same rights against the auditor as a foreseen person. For example, such a class might include a bank or banks which make loans to the audit client, if the auditor knows that his audit opinion is to be used by the client to seek bank financing, even though the bank or banks are not identified. The number of members of such a class, and the aggregate commitment of the class, is sometimes very large.

Foreseeable persons and classes—These are the potentially very large numbers of persons, not identified to the auditor by specific persons or class in a specific transaction, who may foreseeably be expected to receive his audit report when distributed by the client, and in some way to act or forebear to act in reliance upon it. Foreseeable persons have some form of business relationship to or interest in the client which makes such a reliance plausible. They may include public investors in equity or debt securities of the client, purchasers or suppliers of goods or services under substantial or continuing contracts, and possibly such persons as employees and taxing bodies. According to the Second Restatement, an auditor would not be liable to such persons for loss from reliance upon his audit opinion if it were a negligent misrepresentation, but *would* be so liable if the audit opinion were a fraudulent misrepresentation—actual or constructive—to the extent it is determined by the trier of fact that he should expect their conduct to be influenced by his fraudulent deceit.

General public—The mere *possibility* that *anyone* might see the auditor's opinion and rely upon it in some act or forebearance does not bring such persons within the group whose reliance is considered foreseeable to the auditor, and the auditor does not have a duty or liability to such persons. Examples might include retail customers, trade creditors, and regulatory and other governmental bodies of jurisdictions to which the client is subject. The differentiation between the general public and foreseeable persons is even more indistinct than between other classifications, if only because there has not yet been a great deal of need for attempting to define the distinction. [1974, pp. 1209-10]

Since 1965, several judicial opinions have held to the *Ultramares* primary benefit rule, generally because of adherence to earlier controlling precedents. But in at least two significant cases, the courts have accepted the concept of the ALI's *Second Restatement.* In *Rusch Factors, Inc.* v. *Levin* (1968), the "court with characteristic caution diluted the force of that conclusion with alternative rulings that the third-person plaintiffs were primary beneficiaries of the audit work—although third persons had not previously been found to be primary beneficiaries" (Gormley, 1974, pp. 1210-11). (In that particular case, however, the audit was performed at the specific insistence of the plaintiff lender (Isbell and Carmichael, 1973, p. 41).) In *Rhode Island Hospital Trust National Bank* v. *Swartz* (1972), the court "clearly applies the *Second Restatement* but not the primary benefit rule" (Gormley, 1974, pp. 1210-11), even though "the circumstances were such as to come squarely within the primary benefit rule . . ." (Isbell and Carmichael, 1973, p. 41).

The Supreme Court of Canada, in a 1976 decision (*Haig* v. *Bamford*), applied the foreseen class rule to invoke a duty of care that an auditor owed to third parties. The issue was whether "to create a duty of care, it is sufficient that the accountants know that the information was intended to be disseminated among a specific group or class . . . or whether the accountants also needed to be apprised of the plaintiff's identity. . . ." The court held that "actual knowledge of the specific plaintiff who will use and rely on the statement" was too narrow a test, and instead applied a test of "actual knowledge of the limited class that will use and rely on the statement." The court's opinion in that case provided an excellent summary of English, American, and Canadian authorities and decisions that had addressed this issue.

> The opinions are at least evidence of a marked trend toward a change of law, even to those cautious about concluding that the change is already confirmed. The trend suggests the likelihood either that the primary benefit rule is broadening to coincide with the foreseen person concept of the Second Restatement, or that the foreseen person concept is absorbing and superseding the primary benefit rule.
>
> The difference is more than just words. The foreseen person concept, but not the primary beneficiary rule, is in harmony with the *foreseen class* concept.[2]

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2. The difference may be more than "just words" in another sense. In *Rusch Factors*, decided under the primary benefit rule, the court "found the correct measure of damages to be the same as that applied where the parties are in privity, or the amount necessary to place the corporation in the position it would have been in had

> If the primary benefit rule of *Ultramares* is indeed being supplanted by the Second Restatement, it can at least be said that a stable Restatement rule carefully applied and thoughtfully limited should be tolerable, though the size of the foreseen class and transaction is sometimes very large.
>
> However, there is the same infinite gradation of factual differences, and the pressures that may be changing the test from primary benefit to foreseen class could continue to operate in an attempt to make a further change to *foreseeable* class. The foreseen class test would tend to protect powerful and sophisticated lenders, businesses and institutions whose personnel and counsel would make certain that the auditor foresaw their reliance and knew of their transaction, and to exclude from its scope the less powerful and less sophisticated. This could prove distasteful to judges—and to the public—and could lead to semantic stretching by lawyers for plaintiffs arguing that their shareholders, bondholders and creditors are also specific classes whose reliance in their transactions and relationships with the audit client is something the auditor should have *foreseen.* The law changes according to evolving thought and sentiment. How and whether courts would weigh the balance between fault and liability in the future is uncertain. [Gormley, 1974, p. 1211-12]

Isbell and Carmichael find some comfort in the fact that no court in a reported case involving auditors has extended common law liability for negligence to the vast group of merely foreseeable but unidentified third-party users (1973, p. 41). A glimpse of what the future may hold, however, may be found in the court's speculations in *Rusch Factors*:

> The wisdom of the decision in *Ultramares* has been doubted . . . and this court shares the doubt. Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional malpractice? Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost onto the entire consuming public? Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession?

Requirements for Determining Deceit

Third parties bring actions under common law, as noted earlier, on the grounds of deceit (fraud) or negligence. If the action is in deceit, "the plaintiff will have to prove (1) a false representation [of a material fact], (2) some form of knowledge of the falsity [or its equivalent], (3) an intention to induce the plaintiff to act or refrain from action, (4)

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the account been correctly stated. For example, the accountant's negligence produced errors of $33,069.22. The court subtracted $5,000 as the margin of error beyond which the accountants had not warranted correctness and added $1,380 as the reasonable cost of producing a corrected report, to produce a sum of $30,-069.22. Thus the damages were the same as if the parties had contracted for the services" (Marinelli, 1971, p. 121). The liability to foreseen persons under the *Second Restatement* does not appear to be so limited, but would apparently extend to the full amount of the losses suffered by the third party.

justifiable reliance, and (5) resultant damage" (Fiflis, 1975a, p. 103). If the action is for negligence, the first, fourth, and fifth elements will still be necessary, but the second element would be replaced by "a failure to exercise reasonable care or competence in obtaining or communicating the information."[3] The third element involves the issue of the required plaintiff-defendant relationship that was discussed above. The purpose of this section is to elaborate the judicial requirements under common law for the second element of deceit, some form of knowledge of the falsity or its equivalent, commonly referred to as the *scienter* requirement.[4]

The requirement for scienter is essentially a requirement to prove an intent to injure.[5] In some jurisdictions, scienter may be established by proof of any of the following three elements:

1. Actual knowledge of the falsity of the representation.
2. A lack of knowledge of the truth of the representation.
3. A reckless disregard for the truth or falsity of the representation (Marinelli, 1971, p. 123).[6]

Fiflis noted that the definition of scienter in common law cases varies both between jurisdictions and from case to case within a jurisdiction. "Even if one verbal formula is used, the evidence to meet it varies from case to case" (1975a, p. 102).

The scienter requirement is closely related to the privity notion, as can be illustrated through the *Ultramares* case. If the jury were to find that the defendant auditors expressed an unqualified opinion on the financial statements when they had no knowledge of the facts, and if this would support an allegation of fraud, then liability for the tort of

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3. Fiflis, 1975a, p. 103, quoting *Restatement (Second) of Torts*, sec. 552 (Tent. Draft no. 12, 1966).
4. The next chapter will address the question of the need for scienter under SEC rule 10b-5. To a large extent, the notion of scienter discussed in this chapter serves as an introduction to the discussion of its applicability in 10b-5 cases. The notion is appropriately addressed here, however, because it has its roots and formulation in common law.
5. In *Ernst & Ernst* v. *Hochfelder* (1976), the U.S. Supreme Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." In *McLean* v. *Alexander* (1976) the Delaware district court noted that the Supreme Court in *Hochfelder* "explicitly left undefined the parameters of scienter. . . ." In *McLean*, the district court found "the requisite scienter . . . present in the form of knowing misconduct."
6. In *Hochfelder*, the Supreme Court expressly left unresolved the question whether, in some circumstances, reckless behavior is a form of intentional conduct sufficient for civil liability under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 thereunder. The district court in *McLean* found "little reason to distinguish between knowing misbehavior and reckless misbehavior under Section 10b and Rule 10b-5."

deceit or fraud could extend to third parties not in a contractual relationship with the auditor (privity). Without scienter, the case would not be one involving deceit or fraud. As noted previously, the class of persons to whom the auditor is liable for less than fraudulent acts is limited. Under common law, then, the distinction between negligence and fraud is significant, and this distinction rests essentially on the requirement for scienter.

The question of the requirement for scienter and the elements that constitute scienter are further explored in the discussion in the following chapter of the evolution of the auditor's liability for negligence under section 10(b) of the 1934 Securities Exchange Act and rule 10b-5 thereunder.

Liability to Clients

The auditor's exposure to liability to his client has not been a significant source of litigation until recently. This can be explained in part by the relatively unchanged legal climate surrounding that exposure. As noted earlier, liability to clients (established under common law) is based either on the contractual relationship between the two parties or on the law of torts. In either case, claims against the auditor by his client in most jurisdictions would rest in negligence. Negligence results from a failure to exercise due professional care, which essentially means adherence to generally accepted auditing standards.[7]

Charges of negligence against the auditor by the client (or by a bonding company under rights of subrogation) often result from a failure to detect defalcations or misappropriations. In 1926, *Craig* v. *Anyon* established the principle that contributory negligence by the client plaintiff would be a defense by the auditor. Baird noted, but does not identify, a 1937 case that refined this concept by holding that client negligence would be a defense "only when it has contributed to the accountant's failure to perform his contract and report the truth" (1970, pp. 7-8). In his remarks to the Commission on Auditors' Responsibilities in Toronto on July 10, 1975, K. S. Gunning reported a case, then under appeal, in which the client successfully brought action against the auditor for bonuses paid based on overstated profits even though the client's officers (who were not the recipients of the bonuses) were aware of the overstated profits. Gunning asked:

> Just where does this decision leave the cherished myth which we publish in our professional literature that the financial statements are the respon-

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7. Causes of action by third parties against the auditor, such as gross negligence amounting to constructive fraud and deceit, would also be causes of action by clients.

> sibility of the client, and that we as auditors are responsible solely for an expression of opinion on them? If the client company itself can successfully sue an auditor for errors in its own financial statements, where senior officers themselves were aware of those errors and had not disclosed them to the auditors, it would seem that we should stop whistling that tired old tune.

The auditor is also potentially liable to his client for negligence in rendering an inappropriate opinion that damages the client. This places the auditor potentially at risk to the client as well as to third parties for errors in judgment regarding the type of opinion to be rendered and the specific wording to be used. Earle suggested that

> this potential liability places considerable pressure on the auditor when he must make close judgments. If he mistakenly decides that the accounting policies of his client do not conform to generally accepted accounting principles, he may be sued for the damage caused by the alleged misjudgment. Every accountant is aware that his expression of an adverse, qualified, or disclaimer of opinion on the client's financial statements exposes him to the risk of litigation if his client subsequently establishes that the company's accounting policies are authoritatively supported in the professional literature. This is not an attempt to excuse the accountant who too readily delivers an unqualified opinion, but to emphasize a consideration that is too easily overlooked. As matters now stand, the auditor faces the possibility of suit whichever way he decides: by management, on the one hand, or by third parties, on the other. No other profession is obliged to pick its way through such a mine field. [1975, p. 153]

Potential liability also derives from the implicit fiduciary relationship between the auditor and client. Confidential client information obtained during an audit may be disclosed by the auditor only if that disclosure is required for the fair presentation of financial information in conformity with generally accepted accounting principles. Liability would extend for damages caused by breaching the fiduciary relationship through the improper disclosure of confidential information.

There are indications of a recent increase in the number of cases brought against auditors by their clients or by the client's insurance company under rights of subrogation. Those cases are primarily for failures to detect employee fraud but also for alleged deficiencies in the rendering of management advisory services. This phenomenon is occurring at a time when new claims by third parties appear to have peaked or even slightly decreased. The cost of defending against a claim by a client will not be much lower than the cost of defending against a third party plaintiff, although the monetary exposure will likely not be as great in most cases. This development has been too recent to permit an assessment of either its cause or its eventual effect.

3

Auditor Liability Under the Federal Securities Acts

The principal provisions of the federal securities acts that have determined the auditor's civil liability are section 11 of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934 (and rule 10b-5 thereunder). Auditors may also be liable under other sections of the acts. Section 12(2) of the 1933 act and sections 9 and 18 of the 1934 act contain express liability provisions. Civil liability may also be implied under section 17(a) of the 1933 act and section 14 of the 1934 act. However, relatively little litigation involving auditors has taken place under these sections.

The Securities Act of 1933

Section 11 of the Securities Act of 1933 imposes civil liability on the auditor for misrepresentations or omissions of material facts in a registration statement. Levy summarized the effect of that section on the auditor as follows:

1. Any person acquiring securities described in the Registration Statement may sue the accountant, regardless of the fact that he is not the client of the accountant.
2. His claim may be based upon an alleged false statement or misleading omission in the financial statements, which constitutes his prima facie case. The plaintiff does not have the further burden of proving that the accountants were negligent or fraudulent in certifying to the financial statements involved.

3. The plaintiff does not have to prove that he relied upon the statement or that the loss which he suffered was the proximate result of the falsity or misleading character of the financial statement.
4. The accountant has thrust upon him the burden of establishing his freedom from negligence and fraud by proving that he had, after reasonable investigation, reasonable ground to believe and did believe that the financial statements to which he certified, were true not only as of the date of the financial statements, but beyond that, as of the time when the Registration Statement became effective.
5. The accountant has the burden of establishing by way of defense or in reduction of alleged damages, that the loss of the plaintiff resulted in whole or in part from causes other than the false statements or the misleading omissions in the financial statements. Under the common law it would have been part of the plaintiff's affirmative case to prove that the damages which he claims he sustained were proximately caused by the negligence or fraud of the accountants. [1952, p. 39]

Section 11 thus expands auditor liability to third parties beyond that of common law in the following significant ways:

1. Privity is not a necessary element.
2. The burden of proof, beyond proving a material misstatement of fact, is shifted from the plaintiff to the defendant.
3. The auditor owes to third parties a standard of care described as the exercise of "due diligence"—a reasonable investigation leading to a belief that the financial statements are neither false nor misleading.
4. Because proof of fraud or deceit is not necessary, scienter is not required.
5. The plaintiff need not prove that he relied on the financial statements or the auditor's report thereon, but the defendant auditor will prevail if he proves the plaintiff knew of the "untruth or omission."

The first significant judicial interpretation of section 11 did not appear until 1968, and relatively few cases since have alleged auditor violations of section 11 (Marinelli, 1971, p. 123).

> In *Escott* v. *BarChris Construction Corp.* the suit, based upon Section 11, was a class action against a bowling alley construction corporation which issued debentures, and against its auditors for damages sustained as a result of false statements and material omissions in the prospectus contained in the registration statement. . . . There appears to be no need for privity of contract, or knowledge, or gross misconduct for liability to ensue under Section 11.
>
> A defense to an action under Section 11 is a showing that the accountant pursued a reasonable course of investigation and had reasonable grounds to believe and did believe that the statements therein were true and that

> there was no omission to state a material fact. What is a reasonable investigation? "[T]he standard of reasonableness shall be that required of a prudent man in the management of his own property." The court in *BarChris*, saying that the accountant should not be held to a standard higher than that recognized in the profession, held that the diligence pursued by the accountant did not meet that minimum standard. [Murphy, 1973, p. 390]

Gormley suggested that this case "demonstrated prominently that defendants' burden in public securities offerings under section 11 is indeed as heavy as informed persons had long supposed" (1974, p. 1216).

A controversial aspect of the 1933 act concerns the issues of reliance and causation. The auditor's liability is to purchasers of securities who may not have relied on the financial statements or the auditor's opinion or who may not even have known of their existence. Section 11(e) provides a causation defense, but it clearly places the burden on the defendant auditor by providing that

> if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable.

The causation defense is onerous; the defendant must prove that factors other than the misleading statements caused the loss. The courts have rarely considered the causation defense in section 11 cases against auditors because damages in such cases are usually determined in out-of-court settlements. For example, in *BarChris*, the court "deferred decision of this issue until the claim of each individual plaintiff is separately considered." Damages in *BarChris* were settled out of court, so the defendants did not have the opportunity to assert the existence of other factors.

George O. May has remarked,

> I cannot believe that a law is just or can long be maintained in effect which deliberately contemplated the possibility that a purchaser may recover from a person from whom he has not bought, in respect of a statement which at the time of his purchase he had not read, contained in a document which he did not then know to exist, a sum which is not to be measured by injury resulting from falsity in such statement. [1936, p. 69]

Whether the law "can long be maintained" seems moot forty-three years after its passage. Its justness is another matter. The issues of on whom the burden of proof should fall and who should demonstrate the link between the auditor's work and the plaintiff's loss are not easily resolved. The issue appears to have been decided by Congress on public policy grounds based on the climate that existed in 1933 and the objectives of the 1933 act taken as a whole.

Moreover, as the Supreme Court opinion noted in the *Hochfelder* decision, "each of the express civil remedies in the 1933 act allowing recovery for negligent conduct is subject to significant procedural restrictions" that are not applicable when something more than negligence must be proven. "Section 11(e) of the 1933 Act, for example, authorizes the court to require a plaintiff bringing a suit under section 11, section 12(2), or section 15 thereof to post a bond for costs, including attorneys' fees, and in specified circumstances to assess costs at the conclusion of the litigation. Section 13 specifies a statute of limitations of one year from the time the violation was or should have been discovered, in no event to exceed three years from the time of offer or sale, applicable to actions brought under section 11, section 12(2), or section 15. . . ."[1] Section 10 of the 1934 act, under which most 1934 act claims against auditors have been brought, has no comparable restrictions. The higher standard of care required by the 1933 act and the burden of proof it places on the auditor are, then, not without some compensating procedural controls.

The Securities Exchange Act of 1934

Section 18(a) of the 1934 act explicitly imposes liability on the auditor for filing a false or misleading statement.[2] Unlike section 11 of the 1933 act, section 18 exculpates the defendant on proof "that he acted in good faith and had no knowledge that such statement was false or misleading."[3]

The auditor need not, therefore, prove the absence of negligence. As a result of these conditions,

> Section 18 seems to have added very little to the prospects of successful recovery by investors for false or misleading statements against account-

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1. The Court also noted that "Congress regarded these restrictions on private damage actions as significant."
2. "Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement . . . which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading" (15 USC § 78r (1971), Liability for misleading statements).
3. Unlike section 11 of the 1933 act, section 18 applies to both buyers and sellers and requires reliance on the statements by them in all cases.

ants beyond common law deceit actions and section 11 actions. As Professor Loss has pointed out: "Except for avoiding any question that the person making the false statement or causing it to be made can be sued by the buyer or seller notwithstanding the absence of privity between them, it is hard to see what advantage §18 gives the investor that he does not have in common law deceit." Regardless of the utility of section 18 in protecting investors, judicial authority [*Fischer* v. *Kletz* (1967)] has made it clear that accountants are indeed subject to its express liability. [Marinelli, 1971, p. 133]

Marinelli may not have given sufficient attention to the effect of no privity requirement in section 18. The importance of that section may well lie in the absence of a privity requirement. The plaintiff need not have a transaction with the registrant. As the courts restrict plaintiff access under section 10(b) and rule 10b-5, the expressed liability provision of section 18 may become significant.

Implied civil liability has been recognized by the courts under section 10(b) of the 1934 act and SEC rule 10b-5.[4] The second prohibition of the rule requires a plaintiff buyer or seller of securities to establish that the auditor (though not specifically mentioned in the section or the rule) made "an untrue statement of a material fact or omit[ted] to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading."

The SEC enacted rule 10b-5 in 1942 as a disciplinary weapon for its own use, "for the purpose of curing a peculiar hiatus in the scheme of federal securities regulation that provided a fulsome system of penalties for the fraudulent seller of securities, but was completely silent as far as fraudulent purchases were concerned" (Sommer, 1972, p. 26).

Rule 10b-5 was intended purely as an enforcement tool for the Commission. In 1946 an imaginative plaintiff's counsel and a creative court com-

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4. The pertinent portion of section 10(b) reads: "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 facilities of any national securities exchange. . . . (b) To 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" (15 USC 78j(b) (1971)). Rule 10b-5 reads: "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, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security" (15 USC 78j(b) (1964)).

> bined to yield the conclusion that Rule 10b-5 was not only available to the Commission for enforcement purposes but was available to private claimants as well who could establish they had been harmed by a violation of the Rule. Thus was opened the floodgate through which oceans of litigation have passed in the intervening twenty-six years, virtually to the point that other more explicit liability-creating provisions of the federal securities laws have been vastly overshadowed as litigants sought the benefits of Rule 10b-5. [Sommer, 1972, p. 26][5]

Sommer further points out that the rule omits many details defining the conditions of liability. "There is no specification of those to whom liability may run, there is no measure of damages, there is no limitation upon those who may be held responsible." Similarly, the rule does not state that showing reasonable investigation and belief is an adequate defense. While in some jurisdictions auditors had been held liable to third parties under the rule for mere negligence in rendering their opinions, prior to the *Hochfelder* decision it was not clear whether negligence created monetary liability for a rule 10b-5 offender (Sommer, 1972, p. 31-32).[6]

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5. Milton V. Freeman (1967, p. 922), the drafter of rule 10b-5, reported the origination of the rule. "It was one day in the year 1943, I believe. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, 'I have just been on the telephone with Paul Rowen,' who was then the S.E.C. Regional Administrator in Boston, 'and he has told me about the president of some company in Boston, who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?' So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where 'in connection with the purchase or sale' should be, and we decided it should be at the end. We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, 'Well,' he said, 'we are against fraud, aren't we?' That is how it happened. Louis [Loss] is absolutely right that I never thought that twenty-odd years later it would be the biggest thing that had ever happened. It was intended to give the Commission power to deal with this problem. It had no relation in the Commission's contemplation to private proceedings. How it got into private proceedings was by the ingenuity of members of the private Bar starting with the *Kardon* case. It has been developed by the private lawyers, the members of the Bar, with the assistance or, if you don't like it, connivance of the federal judiciary, who thought this was a very fine fundamental idea and that it should be extended. Recently we have seen among the people who have joined the private Bar in extending it the staff of the Securities and Exchange Commission, and I think that this is something that you can think of as either a good thing or a bad thing."
6. Sommer noted that "despite this uncertainty, however, it is reported that accounting firms or their insurance carriers have paid several millions of dollars in settling claims that appear to have been based on negligence." Suits with little chance of success may have a settlement value because they are expensive to defend and may frustrate the normal business activities of the defendant. Language to this effect was also used by the Supreme Court in *Blue Chip Stamps* v. *Manor Drug Stores* (1975).

In summary, the creation and use of rule 10b-5 have had several consequences. It has extended the auditor's liability to sellers as well as to buyers. For many years in some jurisdictions it created the possibility of huge damages as a result of simple negligence. There can be little doubt that for the thirty-four years between its enactment in 1942 and the *Hochfelder* ruling in 1976, "the legal environment surrounding Rule 10b-5 [was] alive with prospects for an extension of legal doctrines which would increase accountants' risks" (Reiling and Taussig, 1970, p. 41).

Over those years a struggle took place in the courts over whether auditors and others were liable under rule 10b-5 for misrepresentations or omissions that were negligent but not fraudulent (Gormley, 1974, p. 1221). (Fraud requires scienter; negligence does not.)

> The first and third prohibitions of the rule expressly refer to fraud. But the second prohibition, considered in isolation, might be construed to connote negligence, because it refers to an "untrue statement of a material fact" or an "omission of a material fact necessary to make the statements made not misleading in the circumstances." [Gormley, 1974, p. 1221]

The Second Circuit Court of Appeals had a scienter requirement, which mandated a higher degree of auditor culpability than mere negligence. The seventh, eighth, and tenth circuits did not appear to require scienter, and therefore negligence alone sufficed. The ninth circuit had a "flexible duty standard" that avoided the term completely. The disparate appeals court rulings on the scienter issue were resolved by the Supreme Court in 1976 with its decision in *Ernst & Ernst* v. *Hochfelder.*

The complaint in *Hochfelder* charged that Ernst & Ernst had violated rule 10b-5 by its failure to conduct proper audits and thereby aided and abetted a fraud perpetrated by the president of a securities firm. The plaintiff's cause of action rested on a theory of negligent nonfeasance; they "specifically disclaimed the existence of fraud or intentional misconduct on the part of Ernst & Ernst." The Supreme Court granted certiorari to resolve the question of whether a private cause of action for damages will lie under section 10(b) and rule 10b-5 in the absence of any allegations of "scienter." The Court concluded that it will not.

> When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct.

The decision deals solely with section 10(b) and rule 10b-5. It does not remove the negligence standard for civil liability under the federal securities laws generally. The negligence standard under those laws is, however, confined to those sections where Congress expressly intended it to apply or where the courts have determined that imposing liability without scienter in the implied liability sections of the law is compatible with the statutory scheme. For example, a negligence standard is still applicable to liability under section 11 of the 1933 act. Also, a negligence standard applied in a case involving the 1934 act's proxy rules, *Gerstle* v. *Gamble-Skogmo* (1973). In that case the appeals court held it was not necessary "to establish any evil motive or even reckless disregard of the facts."

The Supreme Court's definition of scienter is a strict one. More than knowledge of the alleged wrongful act is necessary to constitute scienter under section 10; there must be actual intent to deceive, manipulate, or defraud.

Still, the courts must determine whether scienter is present in a particular case, and this could lead to a possible erosion of the Supreme Court's strict definition. For example, in a post-*Hochfelder* decision, *Adams* v. *Standard Knitting Mills* (1976), the court found that the auditor acted with scienter in failing to disclose known weaknesses in internal control.[7]

> . . . with full knowledge of Chadbourn's deficient edp and other internal weaknesses, defendant conducted its 1969 audit as though Chadbourn was as sound as a dollar used to be—clearly deviating from GAAP, GAAS and the provisions of Peat's own audit manual. The court finds and holds the proof in this case clearly established that, with the knowledge defendant possessed prior to, during and after the 1969 audit compared against the content of Peat's 1969 Chadbourn financial statements, defendant acted willfully, with intent to "deceive" and "manipulate" and in "reckless disregard for the truth."

The Court noted in *Hochfelder* that "in certain areas of the law, recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act." However, the Court stated that "we need not address here the question whether in some circumstances, reckless behavior is sufficient for civil liability under section 10(b) and rule 10b-5." Liggio (1976) believed that as a result

> the Court may have left the door slightly ajar to its holding that a scienter standard embracing intent is necessary. Most plaintiffs and the SEC will seize on this and argue that recklessness or complete indifference can raise itself to the level of scienter for liability under section 10(b). There are several responses to this particular line of argumentation. First, the very language of the holding only suggests that there "might be," not that there are, circumstances where this would suffice. It does not say that such

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7. This and other post-*Hochfelder* decisions that bear on the scienter requirement are discussed in Olson, 1976.

circumstances would exist or that the Court has any idea whether they in fact do exist. Moreover, given the overall tenor of the opinion, it appears that the common law standard of recklessness would be the standard which the Court would apply; that standard, which has its origins in early New York cases, is one of complete indifference and willful disregard of the truth and is equivalent to a "mental state of mind embracing intent to deceive, manipulate or defraud."

In *McLean* v. *Alexander* (1976), decided in the Delaware district court subsequent to *Hochfelder*, the court stated that

> the auditor's conduct constitutes far more than mere negligence, but falls short of a preconceived actual intent to defraud. His behavior embraces both actual knowledge of material facts not revealed and reckless disregard for the truth. . . . Reckless disregard for the truth is . . . a cognizable basis for liability in common-law fraud actions. There is no hint in *Hochfelder* that the court intended a radical departure from accepted principles. . . . The common law, precedent in other fields, and the legislative history of 10b all buttress the viewpoint that 10b-5 liability ought to attach upon a showing of recklessness.

Litigation against accountants under the securities acts may decrease as a result of the *Hochfelder* decision. However, until the question of recklessness is resolved, plaintiffs could plead a reckless breach of the accountant's duty to adhere to professional standards. Private litigants may allege scienter, but there are procedural remedies to prevent boilerplate allegations of fraud. The Federal Rules of Civil Procedure require that allegations of fraud must be stated "with particularity." If plaintiff and counsel are found to have not believed in good faith that the necessary scienter is present, the Federal Rules of Civil Procedure [9(b) and 11] also provide for appropriate disciplinary action (Liggio, 1976).

> Rule 9(b) motions to dismiss for failure to plead fraud with particularity were frequently granted even before *Hochfelder.* On the other hand, some judges required little or no particularity. In part, one may surmise, this was the result of lingering uncertainty about whether or not the law really required plaintiff to prove actual "fraud" in order to recover damages under Rule 10b-5. That uncertainty no longer exists, and one may predict that in cases attacking their integrity, accountants and others will now be even more successful in requiring counsel bringing the action to spell out in the complaint the basic details of the alleged fraud. [Olson, 1976]

"Rule 11 further provides that for a willful violation the attorney may be subject to disciplinary action" (Olson, 1976). Rule 11 is powerful, but its power has rarely been applied by the courts. A notable exception is found in the judicial proceedings in *Oringer* v. *Equity Funding* (1973). In those proceedings, the court found that

> at the time of signing and filing the Complaint herein, Alvin B. Green did not believe and had no information which could reasonably justify any

> belief that he had any good grounds to support his joinder of Gibson, Dunn & Crutcher [a law firm] as a defendant or to support any of the allegations of the Complaint as they relate to Gibson, Dunn & Crutcher. . . .
>
> In signing and filing the Complaint, Alvin B. Green willfully violated the provisions of Rule 11 of the Federal Rules of Civil Procedure, and the Complaint should be stricken as sham and false insofar as it relates to defendant Gibson, Dunn & Crutcher.

The court ordered Green to pay Gibson, Dunn & Crutcher $2,000 as attorney's fees.

> It should now be clear that plaintiff's counsel must have "good ground" to believe a particular defendant acted with intent to defraud *before* adding him as a defendant. Unless counsel filing class action complaints begin to exercise more discretion, *Hochfelder* should result in more disciplinary action being taken where peripheral defendants are named simply because they have a "deep pocket," and it is hoped that they may be willing to contribute to a settlement. [Olson, 1976]

The effect of the *Hochfelder* decision on the total volume of litigation against auditors is uncertain because of provisions similar to rule 10(b)(5) in state laws. As Kramer noted,

> a number of state securities laws contain a section which is almost identical in its language to Rule 10b-5. The source is the Uniform Securities Act, which has been adopted, with variations, in more than 30 states. The Uniform Securities Act itself contains another provision which is designed to assure that a violation of the section will not be made the basis for civil liability. In some states, however, this provision has not been adopted and in some there have been various other departures from the Uniform Securities Act, so in certain states civil liability could be based on a violation of the section. The *Hochfelder* decision is an interpretation of the federal law only and will not of itself be binding on any court as an interpretation of the law of any state. Therefore, where these state statutes are applicable and could lead to civil liability, there is nothing to prevent a court from concluding that they can be the basis for damages based on negligence of the defendants, even though they may not have had any intent to deceive, manipulate or defraud. Similarly, the *Hochfelder* decision will not of itself control the result to be reached under state common law or other state statutes. It is too early to tell whether the *Hochfelder* decision will lead to an increase in the number of negligence-oriented civil securities suits brought under state law but it is at least possible that it may. [1976, p. 13]

Hochfelder is only the most recent of a series of cases involving the securities laws in which the Supreme Court has significantly limited plaintiff's rights in civil damage suits. In several instances the Court has indicated that securities litigation must be confined. *Hochfelder* is thus one further indication of the Court's reluctance to interpret the securities acts in a manner that would permit the plaintiff bar to assist the SEC (given its budget constraints) in enforcing those acts.

> Several observers have suggested that the Supreme Court decisions in the securities area are a reflection of the Court's concern for its overcrowded

dockets and the expansion of the Federal jurisdiction as an attempted cure-all for problems. Although no opinion has flatly stated this is the reason, the effect of recent securities decisions is to force cases back into the state court system. This process would relieve the severely overcrowded federal judiciary and return to the state courts those cases which properly belong and should be litigated there. [Liggio, 1976]

Liggio also viewed the *Hochfelder* decision as containing

a clear warning that the courts should not seek to interpret the securities laws expansively (to new frontiers) and impose hazards or unreasonable burdens upon experts (such as accountants) who are providing services under the securities laws.

Notwithstanding the restrictiveness of this message, I do not view it as a limitation on the oft-quoted maxim that the securities laws are to be interpreted broadly and not restrictively. The two concepts are not incompatible. The latter is designed to allow the securities laws to deal with persons perpetrating innovative "frauds" not comprehended by the levels of sophistication present in 1934 when the Act was passed—such as those involving new types of securities.

Thus, the need for a catch-all section 10(b). But it should not be used as the vehicle for creating new responsibilities on professionals in connection with securities transactions or to create new causes of action not contemplated by Congress—e.g., for negligence when Congress only intended relief for fraud. [Liggio, 1976]

Class Action Suits and the Contingent Fee System

The class action suit against auditors emerged during the 1960s and significantly increased the risk of litigation both in terms of the number of suits and the magnitude of potential damages. Virtually all landmark cases against auditors during the 1960s and early 1970s have involved public companies, and accordingly, the number of (plaintiff) users of financial data runs into the thousands. [Peat, Marwick, Mitchell, 1976, p. 94]

Class action suits and the contingent fee system, under which lawyers (and possibly other experts) are retained, are procedural tools that make damage suits under section 11 of the Securities Act of 1933 and rule 10b-5 of the Securities Exchange Act of 1934 economically attractive to the plaintiff bar.[8] The attractiveness of such suits results from the size of the monetary awards resulting from litigation or settlement and the portion of those awards granted by the courts to lawyers as fees. Gormley suggested that "the efforts to adapt securities litigation to the class action form is intensely controversial, and the fairness and efficiency of class actions in securities litigations is disputed and unproved" (1974, p. 1214).

8. That attractiveness would be lessened by a statutory limitation to the amount of damages such as the one proposed by the American Law Institute. See chapter 5.

The Legal Bases for Class Actions

An amendment of rule 23 of the Federal Rules of Civil Procedure effective July 1, 1966 "liberalized the conditions under which one or a few purchasers, sellers or, in some instances, holders of securities could institute a collective lawsuit on behalf of themselves and as representatives of other purchasers, sellers or holders who are similarly situated, without the necessity for each member of the class to formally join the lawsuit as a party" (Gormley, 1974, p. 1214). Certain principles—some specifically stated in rule 23 and others derived from judicial interpretation—determine the appropriateness of class actions in particular cases. These were summarized by the court in *Pearson* v. *Ecological Science Corp.* (1973).

1. Do common questions of law and fact predominate, or are they outweighed by the questions of law and fact that are peculiar to individual, potential class members?
2. Can the present plaintiffs fairly and adequately protect the interests of the proposed class?
3. Are the difficulties likely to be encountered in the management of the class action so great that this procedural remedy could impair the just application of the substantive law?
4. Are the benefits accruing to the proposed class members, through consolidation of the claims, sufficient to justify bringing them before the court involuntarily?

The requirement that common questions of law and fact predominate is subject to judicial interpretation in specific cases. Gormley criticized the courts' handling of this element of class actions:

> The predominance of common issues in securities cases is often thrown into doubt by the disparities of successive alleged misrepresentations over a period of time, which properly analyzed involve separate factual issues, and in which the transactions of individual representative plaintiffs result in interests which are conflicting and therefore are not representative of the class as required by the rule. Plaintiffs attempt to gloss over these disparities by claiming that the alleged misrepresentations are the interrelated, interdependent and cumulative product of a common course of conduct, and courts have shown a dismaying tendency to accept these claims in the interest of supporting the class action. The result has been coercive pressure upon defendants to buy peace by settlement.
>
> Auditors and other defendants may be victimized by a mass-produced justice which tortures separate substantive issues applicable to different defendants, such as issuer, executive officers, directors, underwriters, and auditors, into an inappropriate statement of so-called "common" issues, regardless of differences of time and other events and circumstances applicable to different defendants. . . .
>
> If defendants are not to be deprived of their legal right to fair adjudication of these individual issues, cases ruled by courts to be class actions may subsequently prove incapable of orderly administration, because individual, rather than common, issues predominate in fact.

It is the understandable inclination of class action plaintiffs, and a temptation to the courts, to apply presumptions and inferences as to the various individual elements which must be proved in establishing a claim, in an effort to make "manageable" a proceeding which is inherently unmanageable. In a jury case, an award of lump sum damages, or the trial of liability and damages by different juries, raise substantial constitutional issues of due process involving defendants' right to a jury trial. In all cases, constitutional issues are raised by presumptions which shift burdens of proof and by depriving defendants of their right of cross-examination of individual plaintiffs. [1974, pp. 1214-16]

Private action for damages under the 1934 act requires plaintiff's reliance on the defendant's misrepresentation or omissions in making his investment or disinvestment decision.[9] A question arises of what the relationship between the defendant's activity and the plaintiff's injury should be in order to impose liability. As the district court noted in *McLean* v. *Alexander* (1976), "causation is understood to be an essential element of a private action for damages, lest 10b 'establish a scheme of investor insurance' by which 'defendant could be held liable to all the world.' Causation is established by 'the reliance requirement [which] provides the causal link between the non-disclosure [or misrepresentation] and the loss suffered.' "

The very nature of a class action suggests that individual proof of reliance by each member of the class would be impracticable. In *Grad* v. *Memorex* (1973) the district court noted:

Defendants argue that in order to recover, each of the potential 60,000 class members must prove he actually relied on the defendants' alleged misrepresentations and omissions in making his decision to purchase Memorex stock during the relevant time period. Upon this premise, defendants further urge that due process requires they be given the opportunity to depose and cross-examine each class member. If the court were to accept this argument, it is apparent the cause would fail as a class action for two reasons; first, the individual questions of actual reliance would predominate over common questions, and, second, the case would be rendered totally unmanageable, thus preventing findings under 23(b)(3) necessary to certify the class.

In *Societe Generale* v. *Touche Ross* (1975), the district court noted three other concepts of reliance that make class actions feasible.

The first concept is found among some Rule 10b-5 decisions, wherein the investor's "reliance" is based not so much on particular misrepresentations as on the "artificially inflated price" of securities that may have been the result of a series of misrepresentations. This theory has found its most explicit exposition in *Grad* v. *Memorex Corp.* . . .

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9. For a detailed discussion of the reliance issue, see Ruder, 1976.

> The second theory that can be utilized in this action to avoid the actual, individual demonstration of reliance by each claimant is found in the United States Supreme Court's ruling in *Affiliated Ute Citizens of Utah* v. *United States* (1972). In that case, the Court held that when an action proceeds, in whole or in part, on the nondisclosure of material facts, all that is required is that a reasonable investor might have considered the facts withheld as "material" to his investing decision.[10] This reasoning has been extended to apply to firms of certified public accountants. . . .
>
> The final concept is the "constructive reliance principle" announced in *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp* . . . , wherein the United States Court of Appeals for the Second Circuit stated that "[t]he reliance standard also has been relaxed under certain circumstances; for example, if a material omission or misstatement is proven, a presumption may be raised that the plaintiff relied on the deception to his detriment." This rule is particularly applicable to impersonal, open market transactions such as are involved in the instant case: "Where the transaction is accomplished through impersonal dealings, such as on a stock exchange, or for some other reasons the factors that influenced the parties are not readily apparent, the decisions have discussed liability in terms of the 'materiality' of the misrepresentation. . . . This constructive reliance principle is particularly appropriate in class actions where proof of actual reliance by numerous class members would be impracticable."
>
> More recently, in *Tucker* v. *Arthur Andersen & Co.*, the court, after quoting the above language from the *Chris-Craft* case, said: "Allowing a presumption of reliance by a showing of materiality—i.e., constructive reliance—in cases involving open market transactions follows the same reasoning as allowing such a presumption in cases of nondisclosure. In both instances there are practical difficulties in proving reliance. In 'fraud on the market' cases—as opposed to face-to-face dealings—the causation requirement can be satisfied if plaintiffs can show that the misrepresentations affected the market (artificial price inflation) and damaged the plaintiffs. As in cases of nondisclosure, proof of materiality leads to a logical inference of reliance. If the reasonable investor would have been influenced to purchase by the alleged material misrepresentation and omissions then many traders in the market may have been similarly influenced."

In *Pearson* v. *Ecological Science Corp.* (1973), the district court in denying class action status took an opposite view regarding misrepresentations:

> Settled, however, in the view of this court, is the requirement that reliance be shown, in order to recover in cases such as the one at bar wherein the complaint alleges damages ensuing primarily from the communication of brochures and financial reports. . . . Yet, clearly, not every member of the enormous proposed class in the instant case purchased Ecological stock in reliance on each of the communications in issue, and it cannot even be assumed that any particular potential member of the proposed class relied on any of the specific communications.

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10. In *TSC Industries* v. *Northway* (1976), the Supreme Court considered the definition of a material fact under the proxy rules.

> Thus, in view of the requirement of establishing reliance on the communications, judicial proceedings would be necessitated to determine whether, in fact, each individual member of the proposed class relied upon any of the alleged misrepresentations spanning nearly a three-year period. Such a determination would involve an analysis of the sophistication of each buyer, the extent of each buyer's knowledge of the numerous alleged fraudulent representations. Even accepting plaintiffs' characterization of their claim as one of market manipulation—i.e., that the price of Ecological stock was artificially inflated as the result of the totality of the misleading communications—the time and amount of such allegedly inflated price as related to each purchaser would be critical in determining the rights of each individual member of the proposed class.

The viewpoint of the auditor can be found in Henry Hill's suggestion that there should be a "doctrine of proximate cause" for auditors' liability: "I believe there should be some requirement that the plaintiff has read the financial statements if he intends to sue the accountants or the company on the basis that they are misleading. . . . [W]e need to establish some connection between the misdeeds of the accountant and the damages to the investor. We should require the demonstration of some kind of association between the financial statements and the investment or disinvestment decision" (Hill, 1975, pp. 176-77). The "some connection" or "some kind of association" would presumably be a causal link between the work of the auditor and the injury to the plaintiff.

The alternative view is summarized by Gonson:

> If there is trading in the securities of a company, the current financial statements will, of course, affect that trading, and the persons who trade may be damaged by those statements proximately, even though they never read them. That is because analysts read them, and brokers read them, and other people read them, and they make recommendations to others who rely upon those recommendations. The plaintiff who buys is no less injured in such a situation. Why should the accountant's liability be avoided, assuming, of course, that the financials were materially misleading and that the accountant was culpable? [1975, p. 193]

The link between the concepts of reliance and causation was also considered by the Ninth Circuit Court of Appeals in *Blackie* v. *Barrack* (1975):

> Moreover, proof of subjective reliance on particular misrepresentations is unnecessary to establish a 10b-5 claim for a deception inflating the price of stock traded in the open market. . . . Proof of reliance is adduced to demonstrate the causal connection between the defendant's wrongdoing and the plaintiff's loss. We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causational chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a prima facie case. . . .

Defendants argue that proof of causation solely by proof of materiality is inconsistent with the requirement of the traditional fraud action that a plaintiff prove directly both that the reasonable man would have acted on the misrepresentation (materiality), and that he himself acted on it, in order to establish the defendant's responsibility for his loss, which justifies the compensatory recovery.

We disagree. The 10b-5 action remains compensatory; it is not predicated solely on a showing of economic damage (loss causation). We merely recognize that individual "transactional causation" can in these circumstances be inferred from the materiality of the misrepresentation . . and shift to defendant the burden of disproving a prima facie case of causation. Defendants may do so in at least 2 ways: (1) by disproving materiality or by proving that, despite materiality, an insufficient number of traders relied to inflate the price; and (2) by proving that an individual plaintiff purchased despite knowledge of the falsity of a representation, or that he would have, had he known of it.

The issue of reliance is often seen as a matter of choosing between options: a need to prove each investor's reliance on the auditor's work, versus no requisite showing of reliance because, presumably, the market price reflects the alleged misrepresentations. There may be a middle ground, but one that this study can merely suggest. The plaintiff could be required to show that the market price was affected by the auditor's work. However, that might be an impossible task, as suggested by the controversy surrounding the contradictory evidence on the efficiency of capital markets in responding to information. Perhaps further development of the various forms of the efficient market hypothesis will make this suggestion more practicable in the future.

It has been alleged that the courts have shown little restraint in affirming the appropriateness of class actions. The denial of class action status to litigants in some recent cases, however, on the grounds that the requisite conditions were absent lends credence to the views of one observer that "the courts are armed with ample powers to check abuses of class actions; and of late, judges seem confident in exercising those powers" (Andrews, 1975).[11] As a result, "fundamental questions as to the efficacy and use of the class action are finally being given the attention they deserve in the courts" (Liggio, 1973, p. 3).

The fundamental question is whether in fact the class action is unsuitable for most securities litigations because of the absence of predominant common questions and of plaintiffs who are in fact representative of the alleged class. This argument is now being pressed in a number of cases. The issue is critical to the question of whether the class action procedure will continue to be used abusively in securities cases. The struggle is in a critical stage, and the outcome is uncertain. [Gormley, 1974, p. 1216]

11. Evidence for this view can be found in *Eisen* v. *Carlisle-Jacquelin* (1974).

The Effects of Class Actions and the Contingent Fee System

Class actions permit a pro rata spreading of the costs of litigation. The contingent fee system, in turn, essentially shifts the risk to the plaintiff's attorney if the suit is unsuccessful. Contingent fees generally range from 20 percent to 40 percent of the award, "in most cases actually one-third" (Hill, 1975, p. 179; Liggio, 1973, p. 3).

With the remainder of the award often spread thinly among the class of plaintiffs, class actions thus "tend sometimes to shift the focus of interest away from the party allegedly wronged and to the plaintiff's attorney as the individual who has the largest readily identifiable financial interest in the action" (Harlan, 1974, p. 23).

Another commentator expressed it thus: "I am sure I will be accused of being a cynic, but there is little doubt in my mind that in many, if not most of these cases, the only person who is interested in seeking redress is the lawyer; and in fact, he will be the only one that will benefit from this litigious exercise" (Liggio, 1973, p. 3).

The courts have also noted the relationship of class actions and contingent fees to "strike suits." A strike suit is

> a complaint which by objective standards may have very little chance of success at trial [but which] has a settlement value to the plaintiff out of any proportion to the prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment. The very pending of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the suit.[12]

The effect of strike suits has been noted by counsel for the AICPA:

> Strike suits predicated on negligence are easy to begin and virtually impossible to end. Brought as class actions they become difficult to try and still more difficult to settle. Irrespective of their merits, they simply do not go away.
>
> During their pendency, the charges leveled against a firm of certified public accountants constitute a cloud on their professional reputation and a threat to their professional standing. The *in terrorem* effect of the pendency of even the more meretricious litigation creates a settlement value in such lawsuits having no relationship to the quantitative size or qualitative merit of the claim.[13]

In *Grad* v. *Memorex* (1973) the court noted the relationship between class actions, contingent fees, and strike suits.

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12. From the Supreme Court's decision in *Blue Chip Stamps* v. *Manor Drug Stores* (1975).
13. *Brief for the AICPA as Amicus Curiae* before the U.S. Supreme Court in *Ernst & Ernst* v. *Hochfelder* (1976).

> An equally undesirous effect of injudicious application of Rule 23 is the encouragement of "strike suits" brought by unscrupulous plaintiffs (or their lawyers) using the class allegations to coerce defendants—who may have good defenses on the merits—to settle for fear of exposure to the mammoth liability which a class action necessarily raises.
>
> Another aspect of the use of Rule 23 which has caused particular distress and rancor in both defendants and the professional bar is the fact that huge recoveries are oftentimes divided in such a manner that 60% to 80% is distributed thinly among the class members and 20% to 40% (regardless of the amount of work actually performed) goes to the successful attorneys. . . .
>
> The answer to these problems, however, is not to abandon Rule 23 where the stakes are high (it is large cases, after all, for which it is designed), but rather to be more selective in its usage and application. . . .
>
> As for attorney's fees, if the case should settle (and the court hereby expresses no opinion as to the likelihood or desirability of settlement), or if a judgment is rendered in favor of plaintiffs, the court will see that counsels' remuneration is proportionate to the work done and not arbitrarily sliced from the total amount of recovery.

Moreover, courts have recently challenged contingent fee arrangements by

> limiting lawyers' shares of damages to amounts computed by a formula that takes into account the lawyer's time spent and the quality of work involved in a case. For example, the formula approach was recently used by the U.S. Court of Appeals in Philadelphia to reduce a fee from $1.35 million to $.93 million. Clearly, such action by the courts could reduce the number of class action suits by reducing the lawyers' potential monetary award. [Peat, Marwick, Mitchell, 1976, pp. 94-95]

The contingent fee system has existed alongside common law notions of improper attorney conduct. This conduct is described by arcane legal parlance such as *barratry, champerty,* and *maintenance*. Furthermore, efforts to prove the existence of such improper attorney conduct have usually been unsuccessful. For example, in a recent case, *Coopers & Lybrand* v. *Levitt* (1976), allegations of champertous conduct by plaintiffs' attorneys were dismissed by a New York appellate court because "the doctrine of champerty does not exist in this state except as provided by statute."

Whether justice is served by this combination of class actions and contingent fees depends on one's views of "justice" and one's definition of the public interest. There may be no dispassionate observers on the issue. However, alternative views may be pertinent. First, Liggio:

> I do not mean to suggest . . . that I feel securities litigation is without merit or that all members of the Bar seek only to pursue their own self-interest. On the contrary, I believe the threat of litigation and litigation itself in many instances serve a useful purpose; and from a social benefit standpoint there is much to say for it. However, as with all good things, it is abused. [1973, p. 3]

Then, Hill:

> I have heard lawyers assert that the failure of members of a class to receive the benefits of a settlement is not important and what *is* important is the restraining effect on wrongdoers. If that is an honest statement of the justification, the code of Hammurabi is not dead yet. The injured party is awarded the ear of the malefactor which has been judicially severed and the only party who comes out ahead is the guy who cut it off. [1975, p. 179]

Patrick, on the other hand, sees benefits from class actions.

> Much of the observer's reaction to the dramatic increase in class actions depends on his point of view. It all depends on whose ox is being gored. Accountants, lawyers, exchanges, and brokers usually do not appreciate being sued. Judges who have heavy dockets and who feel over-worked sometimes take a dim view of class actions.
>
> Class actions against accountants and lawyers may prove, however, not to be the end of the world for either the accounting profession or for the legal profession.
>
> I have had friends who are office lawyers, and who do a great deal of registration work, tell me that they have doubled their fees as a result of the SEC's action in [*SEC* v.] *National Student Marketing.*
>
> These developments, which have been described by some as a "revolution," may turn out to be not all that bad in the long run for public investors, the accounting profession and for the legal profession, since it will enable the professionals to improve and extend their procedures, improve the quality of prospectuses and reports to the public, and permit larger fees. The class action has achieved a useful purpose in permitting small investors an opportunity to seek relief, as well as some economy of judicial effort by compressing many units of litigation under one roof. [1974, pp. 164-65]

4

Other Sanctions Under the Federal Securities Acts

Other legal sanctions against auditors under the federal securities acts include criminal prosecutions by the U.S. Department of Justice on referral from the SEC and injunctive and administrative proceedings by the SEC.

Criminal Proceedings

Violations of the securities acts that give rise to civil liability are also subject to criminal penalties (fine or imprisonment or both) under section 24 of the Securities Act of 1933 and section 32 of the Securities Exchange Act of 1934 if the violations can be shown to be willful or intentional. Auditors are also exposed to criminal penalties under the federal mail fraud and conspiracy statutes. In *United States* v. *Benjamin* (1964),

> the court announced that the requirement of willfulness or intent could have been met by proving that the defendant had deliberately closed his eyes to facts which he had a duty to see. Other circuits have held that the willfulness requirement of the Securities Acts is satisfied in fraud cases by proof of representations which due diligence would have shown to be untrue. [Murphy, 1973, p. 392]

Burton stated the SEC's position on bringing criminal charges against auditors:

> While virtually all Commission cases are civil in character, on rare occasions it is concluded that a case is sufficiently serious that it should be referred to the Department of Justice for consideration of criminal prosecution. Referrals in regard to accountants have only been made when the Commission and the staff believed that the evidence indicated that a professional accountant certified financial statements that he knew to be false when he reported on them. The Commission does not make criminal references in cases that it believes are simply matters of professional judgment even if the judgments appear to be bad ones. [1975, p. 28]

Perhaps because of the availability of other legal remedies (including injunctions, administrative proceedings, and civil suits by third parties) and absence of the element of personal gain, there have been few criminal actions against accountants. Murphy (1973, p. 392) cited two criminal cases that were prosecuted before 1969:

> *United States* v. *White* (1941) involved the prosecution of accountants, among others, for conspiracy and for using the mails for the distribution of prospectuses for the sale of stock in a scheme to defraud. . . .
>
> *United States* v. *Benjamin* (1964) was a criminal action of conspiracy to sell unregistered securities and to defraud, in violation of the Securities Act of 1933, and using the mails to defraud, brought against an accountant who prepared pro forma statements.

The *Continental Vending, Four Seasons, National Student Marketing,* and *Equity Funding* cases represent more recent and notorious instances of criminal prosecutions of auditors.

The consequence of criminal prosecution to an auditor may go beyond the obvious ones of the costs of defense and the resultant fines and imprisonment. First, a successful criminal prosecution may help to establish civil liability.

> Perhaps an analogy to the antitrust area is valid. When the government sustains a judgment against a company for an antitrust violation, that judgment can be used to establish a *prima facie* case by a private party allegedly injured by the violation. Considerable help is given to the private litigant. A violation of the law is tentatively established, substantially reducing the risk of an unsuccessful suit. The prospect of a criminal suit as well as a civil suit makes a company more willing to acquiesce to a consent decree or some other settlement short of prolonged litigation. Perhaps the government is attempting to facilitate civil suits by resorting to criminal action. The criminal judgment would not have *prima facie* civil power, but evidence would have been gathered and much of the rationale for a civil case would have been developed. Alternatively, where civil suit has already been instituted, as in *Continental*, the threat of criminal action might encourage prompt settlement. [Reiling and Taussig, 1970, p. 43]

Second, the convicted auditor may be unable to continue as a member of his profession.

The prospect of criminal action is particularly threatening to accountants because of its potential impact on their professional lives. AICPA Bylaws 7.3.1, as amended February 20, 1969, specify that membership shall be terminated without a hearing if there is filed with the Secretary of the Institute a judgment for conviction of a crime defined as a felony under the law of the convicting jurisdiction. The Trial Board of the Institute according to Section 7.4 of the Bylaws may expel a member if he has been convicted of a criminal offense which tends to discredit the profession. More significantly, state boards have the power to revoke a CPA's license to practice. However, it has been held that revocation was too severe a penalty where the improper conduct consisted of preparing and issuing certified statements in which the corporate client's liabilities were deliberately understated when the CPA's professional conduct had previously been unobjectionable and his motivation had been solely to give the corporation a chance to stay in business. *Shander* v. *Allen* (1967). [Reiling and Taussig, 1970, p. 52]

Injunctive Proceedings

The SEC has the authority under section 20 of the 1933 act and section 21 of the 1934 act to initiate injunctive actions in the courts to restrain future violations of the other provisions of those acts (including section 10 (b) of the 1934 act).

The consequences of an injunction may extend far beyond an admonition to "do right" in the future. The injunction can be useful to plaintiffs in subsequent civil suits for damages; the same language in the injunction may appear in the private damage suit.[1] The person enjoined is exposed to civil and criminal contempt. An injunction pursuant to a consent decree may require the auditor or firm to "adopt and maintain procedures to prevent future violations . . . and to take all reasonable steps to conduct its professional practice in compliance with such procedures."[2]

Along with a referral to the Department of Justice for consideration of criminal action, the injunctive proceeding is the "Commission weapon most dreaded by the accounting profession" (Sommer, 1975, p. 37). The weapon appears not to have been used against auditors prior to about 1970, but in the succeeding five years at least seven

1. However, a prior injunction obtained by the SEC is not determinative on the issue of liability in a subsequent private suit. See "Comment: The Effect of SEC Injunctions in Subsequent Private Damage Actions—*Rachel* v. *Hill*," *Columbia Law Review*, 71 (November 1971), p. 1332.
2. The language is from the 1973 injunctive proceeding against Laventhol, Krekstein, Horwath & Horwath. The settlement under the accompanying rule 2(e) proceeding specified the procedures to be undertaken to meet the terms of the injunction. This link between injunctive and rule 2(e) proceedings is of recent origin and will be discussed later in this chapter.

injunctions were filed against auditors.[3] "The injunctive proceeding often occurs in a total context which includes civil litigation seeking huge damages from the accounting firm. In some cases, the Commission action follows—sometimes by quite a period of time—the commencement of private litigation; in other cases, it precedes litigation" (Sommer, 1975, p. 37).

The question also arises of auditor's culpability that is necessary for an injunction. Sommer generalized the conditions under which the SEC will bring injunctive proceedings:

> The most difficult problem the Commission confronts whenever it considers a recommendation for the commencement of an injunctive proceeding by the staff is: what is the standard of conduct to which we think accountants should be held? Is it negligence? Is it recklessness, indifference to economic reality? Must there be an element of knowledge or "should have known"-ness? What is the measure of, to use that fine old misused word, scienter?
>
> The first thing I would say is this: the Commission does not consider the auditors the guarantors of the integrity, solvency, honesty, or conduct of their clients. Auditors can be duped just like investors or anyone else and we have refused to authorize actions when it appeared they were the victims of their clients, rather than actionable abettors of their misconduct.
>
> Likewise we do not bring actions because we disagree with the judgments of the auditors—unless, of course, that judgment is so bad that it leads to inferences of a state of mind inconsistent with the integrity demanded of those who practice the accounting profession. We recognize that auditors can differ in their judgments with regard to the propriety of the application of an accounting principle, or the selection of the accounting principle to apply. But, on the other hand, the existence of some authority to support a position, while persuasive, is not conclusive with regard to the Commission's decision to authorize an action; much more is involved in a Commission proceeding. . . .
>
> Put very simply, when the Commission discerns that the auditor has not been alert to his duty, that he has gone through an exercise by rote or that he has not been true to the duty of fair presentation, then in my estimation the Commission should properly authorize an action to enjoin the accountant from a repetition of those faults. [1975, pp. 37-38]

This is essentially an application of the flexible duty standard to injunctive proceedings that had evolved in the ninth circuit in rule 10b-5 cases. Since the injunctive action will probably cite a violation of that rule, this is hardly surprising.

Should the standard of care required of the auditor be the same under an SEC injunctive action as under a rule 10b-5 private action? The SEC's position, which it held both before and after *Hochfelder*, is

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3. Gormley, 1974, p. 1224, lists six of these suits.

that merely negligent conduct is sufficient in civil injunctive proceedings.

> The SEC argues vigorously in their cases throughout the country that—at least for the purposes of their Rule 10b-5 civil injunctive actions—they need not prove scienter, they need not prove constructive knowledge of fraud, they need not prove reckless disregard. They argue that mere negligence is enough to enjoin a director or a broker-dealer, a corporate officer, an accountant, or indeed, an attorney, under the antifraud provisions of Rule 10b-5. The typical argument that the SEC litigation attorney will make to the Court in this regard is that an SEC civil injunction is remedial in nature. It is merely prophylactic relief designed to prevent repeated statutory violations in the future. The SEC has prevailed in persuading at least some courts to credit this approach—probably because the defense lawyers in those cases weren't doing their jobs. So negligence has become fraud under Rule 10b-5! [Matthews, 1975, pp. 105-06]

Matthews argued that this trend is undesirable because of the consequences to the auditor of injunctive proceedings that were noted above.

> I think, because of the severe direct and indirect adverse consequences of an injunctive decree—particularly against a professional, a lawyer, an accountant, or other professional—that this trend in the law is wrong and ought to be reversed. I think the standards ought to be the same under Rule 10b-5 whether the relief sought is an injunction or money damages. I would argue that lawyers ought to be "urging" courts that the standards in an injunctive case ought to be just as rigid as the standards in a private action—that negligence is not enough, and that a showing of scienter, reckless disregard, or constructive knowledge of fraud should be required. [1975, p. 106]

In *Hochfelder*, the Supreme Court disclaimed the need to consider whether scienter is a necessary element in an action for injunctive relief under section 10(b) and rule 10b-5. In a "post-*Hochfelder*" memorandum, the SEC's general counsel stated that the requirement for scienter in private actions under section 10(b) and rule 10b-5 "should not be construed as necessarily carrying over into Commission actions for injunctive relief for violations of that statutory provision and that rule. . . . In *Hochfelder* the plaintiffs sought civil money damages from an accounting firm whereas Commission actions seek to protect the public by enjoining violations of the federal securities acts."[4]

In a post-*Hochfelder* opinion in *SEC* v. *Bausch & Lomb* (1976), the district court stated "that the *Hochfelder* holding must be read to

4. *SEC General Counsel's April, 1976 Memorandum Regarding* Ernst & Ernst *v.* Hochfelder, Bureau of National Affairs, no. 113, June 10, 1976, p. J-2. That memorandum also indicates SEC strategy in seeking future injunctions until the scienter issue is resolved.

impose a *scienter* requirement in the suit for injunctive relief brought by the SEC. Although not obliged to reach the question by the facts of that case, the Supreme Court used reasoning which appears to compel that result. . . . As the Court reads the majority opinion in Hochfelder, *scienter* must be pleaded and proved whether suit is brought by the SEC or by a private litigant." The case is currently under appeal by the SEC, an action influenced by the appeals court decision in another recent case.

In that case, *SEC v. Universal Major Industries* (1976), the appeals court held that *Hochfelder* did not undermine that circuit's position "that in SEC proceedings seeking equitable relief, a cause of action may be predicated upon negligence alone, and scienter is not required." The court's opinion was blunted, however, because of its assertion that scienter was present in the defendant's actions.

> Indeed, our decision need not rest on our rejection of appellant's negligence-scienter argument, because the District Court found that appellant in some circumstances knew and in other circumstances had reason to know that his client was engaging in illegal transactions with the aid of appellant's letters and that appellant's acts were performed with knowledge or reckless disregard of the truth. This, we have held, is sufficient to establish scienter.

Until the scienter issue is finally resolved by the Supreme Court, the SEC is likely to seek injunctive relief if it believes it can reasonably assert reckless disregard, scienter, or both. If the test becomes one of scienter, the SEC may extend its investigations to find the necessary scienter. This could lead to more criminal references to the Department of Justice. If only negligence, but not scienter, can be established, the commission may be content with bringing rule 2(e) proceedings which are discussed later in this chapter.

An additional issue remains. At the (non-jury) trial on the final or permanent injunction, the SEC must prove both a statutory violation and "equity" for an injunction (Matthews, 1975, p. 140). The preceding material on the standard of care is addressed to the question of whether a statutory violation has in fact occurred. A demonstration of a need for equity requires that there be "a reasonable likelihood or 'cognizable danger' that future violations will occur if an injunction is not imposed" (Matthews, 1975, p. 140). Matthews argued that "the mere establishment of a past violation *will not necessarily* support an inference of future violations, particularly where the defendant establishes good faith" (1975, p. 142).[5]

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5. However, the SEC's general counsel in its April 26, 1976, post-*Hochfelder* memorandum stated that "it may be possible to argue . . . that it is not necessary in order to obtain an injunction that we establish a past violation of law."

The courts, understandably, give great weight to the SEC's expert judgment of the immediate need for injunctive relief. Ordinarily, the requested injunction will be issued, even, as some have alleged, on incomplete evidence (Guzzardi, 1974, p. 147).

> But the courts have become more insistent that the weapon not be misused. District Judge Harold Tyler, Jr. reproved the SEC for extracting an injunction when all the Commission was alleging was fraud committed by one person in a single instance. Under such circumstances, decided Tyler, "we perceive no basis for dispensing with the evidentiary hearing normally required simply because the plaintiff is a government agency." In addition, the Southern District Court of New York criticized the Commission when it moved for an injunction without establishing first "some cognizable danger of recurrent violation, something more than the mere possibility that serves to keep the case alive." And Judge Henry Friendly of the Second Circuit, perhaps the most respected man on the bench when it comes to securities matters, has warned the SEC that "its practice of requesting the issuance of preliminary or temporary injunctions based solely on incomplete affidavits and transcripts of testimony taken *ex parte* in an SEC private investigation, in the absence of an adversary evidentiary hearing, would be wholly unacceptable in the Second Circuit.". . .
>
> Despite these rulings, the Commission continues to press obstinately for injunctive actions and ancillary relief. It takes the position that it is applying for a "statutory" injunction, meaning one that it must seek in order to discharge its statutory obligations. It argues that the standards which apply to private litigants need not be met by the Commission. [Guzzardi, 1974, pp. 147, 192]

Two recent district court cases testify to the courts' watchfulness on the "reasonable likelihood" question. In *SEC* v. *Bausch & Lomb* (1976), the court held that "even had a violation been established, the record . . . does not warrant the grant of this extraordinary remedy. The SEC simply has not convinced this Court that absent an injunction there is a reasonable likelihood that defendants will violate the securities laws in the future. . . . The Court finds no pattern of past violations suggesting that defendants should be enjoined." In a case in which the SEC sought an injunction against the public accounting firm of Arthur Young & Company, *SEC* v. *Geotek* (1976), the court concluded that "even if a violation of the securities laws, as contended by the SEC herein, were found, the evidence is insufficient to show a reasonable likelihood or expectation that AY would commit further violations in the future."

An interesting argument on the "reasonable likelihood" question is found in the SEC's appeal brief in *SEC* v. *Koracorp Indus.* (1976). There the SEC argued that

> defendants' "continuing assertions that their past actions are blameless . . . must be considered by the court below in critically examining their protestations that there is no reasonable likelihood of future violations." This seems dangerously close to an argument that if auditors defend their conduct in failing to discover management fraud, their failure to consent

> immediately to an injunction against future similar failures is evidence that they should be enjoined from similarly failing in the future! If this proposition were carried to the extreme, the only way to defend an injunctive action would be to admit that you violated the statute in the past and argue only about the likelihood of future violations. In other words, you can admit your guilt and be enjoined or deny your guilt and thereby prove that you should be enjoined. [Olson, 1976]

Auditors may have inadequately challenged the commission in the past as a result of their failure to see the consequences of a civil injunction. The number of future challenges might be expected to increase as a result of greater awareness of the effect of injunctions, the favorable rulings in *Bausch & Lomb* and *Geotek* on the issue of the reasonable likelihood of future violations, and the decision in *Bausch & Lomb* that scienter, not negligence, is a necessary element for injunctive relief under rule 10b-5.

Administrative (Rule 2(e)) Proceedings

Rule 2(e) of the SEC's rules of practice is part of

> a regulatory scheme by which the Commission seeks to protect the public and the integrity of the Commission's own processes from incompetent, unethical or dishonest attorneys, accountants and other professionals and experts. As the agency charged with the responsibility of protecting investors in securities, the Commission is necessarily concerned that the accountants, attorneys and other professionals who practice before it be worthy of the trust that the investing public and the Commission are compelled to place in them. Moreover, since the securities industry is a complicated one which trades in "intricate merchandise," the investing public is especially vulnerable to injury by the incompetent, unethical or inept professional. As the Court of Appeals for this Circuit has noted, "In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar." . . . Rule 2(e) is a measure to prevent the often irreparable harm that untrustworthy securities practitioners can all too easily—and quickly—cause at the expense of public investors.[6]

Under rule 2(e), the commission has the power to deny, temporarily or permanently, the privilege of appearing and practicing before it of an auditor who is found: (1) "not to possess the requisite qualifications to represent others," (2) "to be lacking in character or integrity," (3) "to have engaged in unethical or improper professional conduct," or (4) "to have willfully violated, or willfully aided and abetted the violation of any provision of the federal securities laws" (17 CFR 201-2(e)).

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6. *Touche Ross* v. *SEC*, "Memorandum of Points and Authorities in Support of Defendants' Motion to Dismiss" (1976).

In addition, the commission may suspend from appearing or practicing before it an auditor who has been: (1) "convicted of a felony, or of a misdemeanor involving moral turpitude," (2) the subject of a revocation or suspension of his license to practice, (3) "permanently enjoined . . . from violation . . . of any provision of the federal securities laws," or (4) "found by any court . . . or found by this Commission in any administrative proceeding . . . to have violated . . . any provision of the federal securities laws . . . (unless the violation was found not to have been willful)" (17 CFR 201-2(e)).

Procedures are specified whereby the suspended auditor may petition the commission to lift the suspension. Of particular note is the specification that

> In any hearing . . . the staff of the Commission shall show either that the petitioner has been enjoined . . . or that the petitioner has been found to have committed or aided and abetted violations . . . and that showing, without more, may be the basis for censure or disqualification; that showing having been made, the burden shall be upon the petitioner to show cause why he should not be censured or temporarily or permanently disqualified from appearing and practicing before the Commission. In any such hearing the petitioner shall not be heard to contest any findings made against him or facts admitted by him in the judicial or administrative proceeding upon which the proceeding under this paragraph (3) is predicated. . . . A person who has consented to the entry of a permanent injunction . . . without admitting the facts set forth in the complaint shall be presumed for all purposes under this paragraph (3) to have been enjoined by reason of the misconduct alleged in the complaint. [17 CFR 201-2(e)]

Thus,

> the Commission can suspend a professional from practice before it on the basis of an injunctive decree and that, in any hearing before the Commission to lift that suspension, the facts are no longer open to argument. That is, there cannot be a relitigation of the merits of the violation. That is because the professional is presumed to have been found by the court to have committed the misconduct alleged in the complaint, even if the consent decree was entered without admitting or denying the allegations, as is usually the case. The only matters that can be considered by the Commission are matters in mitigation, bearing on what sanction the Commission should impose upon the professional, in the public interest. . . .
>
> Accordingly, it is important for a professional who is named as a defendant in a Commission injunctive action to consider the possible consequent Rule 2(e) effect if he is negotiating a settlement. Often, it will be possible to negotiate the Rule 2(e) consequence in tandem with the negotiation for settlement of the injunctive action. [Gonson, 1975, pp. 195, 199]

An example of this is found in the settlement with Laventhol, Krekstein, Horwath & Horwath, reported in Accounting Series Release no. 144 (May 23, 1973).

Rule 2(e) mentions only three sanctions available to the SEC: temporary suspension, permanent suspension, and censure. Censure is mentioned only as an alternative after a permanent injunction or criminal conviction involving violation of the federal securities laws (Bialkin, 1975, p. 824). Starting in 1973, the SEC began to devise innovative sanctions against auditors under the rule, among which have been—

1. Peer reviews and inspections of accounting firms to determine the extent of compliance with professional and firm auditing standards and procedures.[7]
2. Restrictions for specified periods against mergers with other firms.[8]
3. Prohibitions for specified periods against undertaking new engagements likely to result in filings with the SEC.[9]
4. Requirements to develop and implement auditing procedures for certain types of transactions.[10]
5. Censure of firms, other than following permanent injunctions or criminal convictions.[11]
6. Imposition of continuing education programs.[12]
7. Requirements to give notice of the Commission's findings to potential new SEC clients.[13]
8. Encouragement of a firm to merge with a larger firm, as a condition of terminating other provisions of the consent decree.[14]
9. Prohibition of a partner from acting as or being a partner for a ten-month period.[15]

Many of these sanctions involve agreements to institute new or improved control procedures and to subject those procedures to an independent compliance review. Sommer views this approach as being neither punitive nor retributive, but rather as providing assurance that the possibility of recurrence of specific problems caused by pervasive control deficiencies will be reduced. He has also denied that "it

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7. "In re Laventhol, Krekstein, Horwath & Horwath," Accounting Series Release no. 144 (May 23, 1973).
8. ASR no. 144.
9. ASR no. 144.
10. "In re Touche Ross & Co.," Accounting Series Release no. 153 (February 25, 1974).
11. "In re Arthur Andersen & Co.," Accounting Series Release no. 157 (July 8, 1974).
12. "In re Benjamin Botwinick & Co.," Accounting Series Release no. 168 (January 13, 1975).
13. "In re Lou, Gose & Co.," Accounting Series Release no. 160 (August 27, 1974).
14. "In re Wertheimer, Fine, Berger, & Co.," Accounting Series Release no. 167 (December 24, 1974).
15. "In re Benjamin Botwinick & Co.," Accounting Series Release no. 168 (January 13, 1975).

is the ultimate design of the Commission to create situations which would result in all the 'Big Eight' being under such review procedures" (Sommer, 1975, p. 37).

As with all the other sanctions that may be imposed on auditors, the question arises of the standard of care that the auditor must follow to avoid commission action under rule 2(e).

The types of conduct that can lead to temporary or permanent suspension (and presumably to the more innovative sanctions recently devised) can be summarized in three categories:

1. A finding of the absence of certain personal qualities (not possessing the qualifications to represent others or lacking character or integrity).
2. An adverse finding by a court, the SEC, or a state licensing body of actions that for the most part involve something more than ordinary negligence.
3. A finding by the commission of unethical or improper professional conduct.

The first of these categories "suggest[s] no objectively determinable standards and hence constitute[s] virtually no restraint upon Commission disciplinary action. The Commission quite properly has not sought to use either of [the two grounds included in this category] as the basis for any of its recent proceedings" (Bialkin, 1975, p. 831).

The second category generally requires either willful intent or an act evidently so reprehensible as to result in a criminal conviction or loss of license. However, it also permits the institution of rule 2(e) proceedings upon the entering of a permanent injunction. As noted earlier, the SEC believes, and an appeals court has agreed, that ordinary negligence is sufficient for it to seek and obtain a civil injunction. Negligence thus appears sufficient to sustain a rule 2(e) proceeding via the injunction route.

With regard to the third category, in Accounting Series Release no. 73 (1952),

> the Commission ruled that a finding of "improper professional conduct" under 2(e) does not require a showing of intentional misconduct. The Commission stated: "We accept respondent's assertions that they acted in good faith and accordingly do not find any willfulness in the sense referred to by them. However, *in a disciplinary proceeding under Rule 2(e)*, we are not required to make such a finding. . . ."
>
> At the present time, however, discussion of the standards in 2(e) proceedings cannot be very informed and is of little practical significance. In only one of the recent proceedings did the Commission expressly point to a 2(e) ground and find "improper professional conduct." In all the other recent proceedings the Commission did not point to a particular 2(e) ground. Only noncompliance with various generally accepted accounting

principles or generally accepted auditing standards was alleged. [Bialkin, 1975, p. 831]

A further issue is whether the SEC's implied authority to establish qualifications for those practicing before it gives the commission the authority to impose sanctions under rule 2(e). This has rarely been tested in the courts. All of the known rule 2(e) proceedings "were imposed by consent in settlement of the proceedings and not after an adversary adjudication. Thus, the question of the extent of the Commission's authority to impose such sanctions in the absence of consent remains undetermined" (Bialkin, 1975, p. 824).

Litigation to test that authority may be moot. As Fiflis (1975b, p. 187) noted, "the word 'consent' in 'consent decree' can be likened most to the 'I do' in a 'shotgun wedding.' " "Consent" may be easily obtained to avoid the imposition of the even more severe sanctions of criminal or injunctive proceedings and also to avoid the high costs of litigation and an extended period of unfavorable publicity.

There have been only two challenges to the commission's authority to proceed against a professional under rule 2(e). In *Kivitz* v. *SEC* (1973), the court set aside an SEC order suspending the right of an attorney to practice before the commission for two years. The court dismissed the 2(e) proceeding because it could not conscientiously find that the evidence supporting the commission's position was substantial.

On October 12, 1976, Touche Ross & Co. instituted an action in a federal district court to enjoin an SEC rule 2(e) proceeding (*Touche Ross & Co.* v. *SEC*, "Complaint"). That suit challenged the SEC's authority under the securities acts "to conduct disciplinary proceedings or to suspend or disbar accountants or other professionals from practicing before it." The complaint asserts that

> in the absence of express authority from Congress, the SEC does not have the inherent or implied authority to conduct hearings involving accountants, attorneys and other professionals, or to discipline them, thus acting both as prosecutor and judge in the proceeding, because, *inter alia*, the authority to act as judge and prosecutor should be accorded to administrative agencies only to the extent expressly mandated by Congress.
>
> The SEC's Order instituting Rule 2(e) proceedings alleges not only a willful violation of specified statutes and rules, but also states that the acts charged constitute "improper professional conduct". Presumably, this is merely a redundancy, but if the Order is intended to assert a power over professional conduct independent of violations of the federal securities laws, it is clearly beyond any authority that could legally be exercised by the SEC.

The Touche complaint states that "it was a clear abuse of discretion for the SEC not to have chosen to bring its charges . . . in a federal court. . . .The relief requested herein is not intended to foreclose the SEC from asserting the same claims contained in its 2(e) Order in a complaint filed in a federal court." In an injunctive action, the "scienter" and "reasonable likelihood of recurrence" criteria mignt impose more stringent tests for determining an auditor's culpability.

The SEC, in its "Memorandum of Points and Authorities in Support of Defendants' Motion to Dismiss, " filed December 7, 1976, moved "to dismiss the complaint in this action on the ground that the plaintiffs have improperly failed to exhaust their administrative remedies, which are adequate for their purposes, and resort to which will cause the plaintiffs no irreparable injury."[16]

Some interesting consequences follow from the settlement of rule 2(e) proceedings by consent decrees:

> These are not the same as findings of guilt, of course, and do not formally have the force of law. But publication of a consent decree tends to stir up ideas about the party involved: the decree has an effect somewhat similar to those lines in old movie credits about resemblance to anyone living or dead being a coincidence. The decree states explicitly that the party of the second part does not admit any guilt—but that he agrees to stop doing whatever it was anyway. The decree also becomes a kind of law because it shows, as Commissioner Loomis has helpfully explained, "that the Commission believes the facts in the case are a violation."
>
> Thus consents can be used to set important precedents, an arrangement that has certain advantages from the SEC's point of view. The conventional means of establishing a precedent is for the Commission to put out a proposal for comment, review the responses, perhaps hold hearings, and then rule. But this is all very time-consuming, and the Commission can become impatient coping with arguments against what it believes to be right. Consent decrees circumnavigate that necessity. [Guzzardi, 1974, p. 192]

The very procedures under which rule 2(e) proceedings take place have also been criticized. At the most fundamental level is the issue of whether the same body that initiates a complaint should be the one to determine the validity of the complaint and the resultant penalties (Guzzardi, 1974, p. 146). That issue has also been raised in *Touche Ross* v. *SEC.* Beyond that, the specific procedures used in rule 2(e) proceedings have been challenged, although apparently not through litigation. The December 1974 issue of *Fortune* carried an article containing an extensive catalogue of alleged procedural "peculiarities," to which SEC Commissioner Loomis responded: "I don't think you can prove that we violate due process" (Guzzardi, 1974, p. 146).

An Advisory Committee on Enforcement Policies and Practices, created at the request of the SEC, consisting of John A. Wells (as

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16. The Touche Ross suit is unresolved as of February, 1977.

chairman), Manuel F. Cohen, and Ralph Demmler, made recommendations in 1972 to improve the procedures surrounding rule 2(e) actions.[17] Among the Wells committee recommendations were these:

- A statement from the respondent should accompany the report that the staff makes to the Commission after an investigatory hearing.
- The Commission should make clear in its communications to respondents that initiation of an investigation does not mean that the SEC believes that there has been a violation. (A similar disclaimer might be added in press releases.) And, when the SEC decides to make a charge, it should as a general practice advise the people whom it has been investigating that an injunction is being brought or administrative proceedings started. The defendant should be given a reasonable period of time to give his own version of the facts.
- A list of the witnesses and a statement of the legal theories that the staff intends to use at an administrative hearing should ordinarily be made available in advance to the defendant.
- A person against whom no further action is contemplated should be informed that the case is closed.
- The Commission should designate an SEC official to audit the investigative practices of the staff, to make sure that the staff is fair, prompt, and efficient in all proceedings.
- Where violations have not injured public investors and are unlikely to recur, the Commission should confine itself to issuing a private reprimand.

> There is no sign that the Commission has any intention of implementing these proposals. [Commissioner] Pollack says, "Some Wells recommendations would interfere with our carrying out our duties in an efficient way." And [Commissioner] Garrett says, "No Wells Committee recommendations are under active consideration at the present time." [Guzzardi, 1974, p. 196]

Apart from the legal and procedural issues, some of the more innovative procedures consented to in recent rule 2(e) proceedings raise the spectre of the SEC's intrusion into the area of the creation of specific professional standards.[18] This intrusion may take two forms:

1. Language in a proceeding indicating auditor responsibilities not prescribed in the literature. (An example is the view expressed in Accounting Series Release no. 153 that successor auditors must review the work of predecessor auditors. A refusal by the client to permit the necessary communication should be grounds for reject-

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17. The Wells Report is discussed in Daley and Carmel, 1975.
18. For a discussion of sanctions against auditors and others pursuant to consent decrees in civil injunctive actions, see Seidler and Wiesen, 1976.

ing the engagement. Professional literature at the time did not make predecessor-successor communications mandatory. Moreover, the present standards, while requiring such communication, leave room for the exercise of professional judgment on the effect of a prospective client forbidding such communication.)

2. Language in a consent decree requiring an auditing firm to develop specific audit procedures not currently covered by professional literature. (An example is Touche Ross's consent in Accounting Series Release no. 153 to develop and submit to the SEC procedures for the audit of related party transactions. An SAS on the subject did not exist at the time of ASR no. 153.)

   Burton stated that

> it should be emphasized that the enforcement program is not used as a vehicle by which fundamentally new professional standards are established. The present generally accepted auditing standards of adequate technical training, independence of mental attitude, due professional care, adequate planning and supervision and sufficient competent evidential matter, are perfectly adequate to assure sound auditing if conscientiously applied to each case. [1975, p. 20]

That may be, but the SEC has also traditionally left the specific implementation and interpretation of those standards to the accounting profession. At the least, rule 2(e) proceedings and the accompanying consent decrees provide a vehicle for selective departure from that philosophy.

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The American Law Institute's Proposed Federal Securities Code

The Federal Securities Code, a project of the American Law Institute (ALI) under the direction of Professor Louis Loss (the "Reporter"), is an attempt to consolidate present federal securities statutes, rules, and, to some extent, cases. If adopted, the code will eliminate many of the differences between the 1933 and 1934 acts in the standard of care imposed on auditors and the consequences of failure to meet that standard. "In its basic approach to corporate disclosure, the Code creates a system of registering issuers rather than issues, mandates a regular reporting and disclosure system for those issuers and sets forth the disclosure conditions under which distributions of securities may be made" (Chalmers, 1974, p. 101).

Through February 1977, the ALI has published four tentative drafts, each addressing various parts of the proposed code, and *Revision of Tentative Drafts 1-3.* Completion of the project is anticipated in 1978 or 1979 after further drafting and revision.

The portions of the code that most significantly affect the auditor's responsibilities and liabilities are considered in this section.

Definitions

Part II of the code, "Definitions," defines two sets of terms affecting auditors that appear in subsequent parts:

1. Knowledge and scienter[1]

Sec. 251A. [*Knowledge.*] "Know" and its derivatives include awareness by a person of a high probability of the existence or nonexistence of a particular fact, unless he actually believes the contrary.[2]

Sec. 296AA [*Scienter.*] A person makes (or . . . causes, commands, induces, procures, or gives substantial assistance to, the making of) a misrepresentation with "scienter" if he (a) knows that the matter is otherwise than as represented, (b) does not have the confidence in its existence or nonexistence that his representation expresses or implies, or (c) knows that he does not have the basis for his representation that it expresses or implies.

The code thus constructs two degrees of knowledge. *Knowledge* is used in its ordinary sense; *scienter* includes both knowledge and its equivalent expressed in terms of recklessness. It would be harder for a plaintiff to establish scienter than to establish negligence. However, it is easier to establish scienter as defined in (b) and (c) of section 296 AA than to establish knowledge as defined in section 251A.[3] Obviously, the establishment of knowledge of a falsity establishes scienter, as clause (a) of the scienter definition indicates. Clause (b) is traceable to the "reckless disregard" concept.[4] Clause (c) brings the lack of knowledge of the truth of a matter under the definition.[5] Also, scienter is defined only in relation to misrepresentations, not fraudulent acts.

2. Fact, misrepresentation, and estimates.

Sec. 234A. [*Fact.*] "Fact" includes a promise, prediction, estimate, projection, motive, opinion, or law.

Sec. 259. [*Misrepresentation.*] (a) [*General.*] "Misrepresentation" means (1) an untrue statement of a material fact, or (2) an omission to state a material fact necessary to prevent the statements made from being misleading in the light of the circumstances under which they are made.

(b) [*Estimates, etc.*] A statement of fact . . . is not a misrepresentation if it (1) is made in good faith, (2) is reasonably based on facts, including whatever investigation is appropriate under the circumstances, when it is made, and (3) complies with any applicable rule so far as underlying assumptions or other conditions are concerned.

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1. All quotations from the code are from the *Reporter's Revision of Text of Tentative Drafts Nos. 1-3* (1974) unless otherwise noted.
2. The use of the word "include," rather than the word "is," suggests that there may have been a conscious decision to allow for an expansion of the definition.
3. This hierarchy does not conform with the Supreme Court's usage in *Hochfelder.* Nor does it conform to the Court's definition of "scienter" as a "mental state embracing intent to deceive, manipulate, or defraud." It is likely that the ALI will review its definitions in the light of recent developments, particularly the *Hochfelder* case.
4. As was pointed out earlier, the Court in *Hochfelder* did not determine whether reckless behavior is a form of intentional conduct.
5. Reporter's comment to section 251A of *Tentative Draft no. 2* (1973).

Although forecasts, estimates, and projections are "facts," it appears that incorrect forecasts, estimates, and projections would not be misrepresentations if they complied with SEC rules and were made in good faith after reasonable investigation. "In any event, the language reflects the truism that an estimate (or some other 'fact' within section 234A) does not retroactively become a misrepresentation *merely* because the facts turn out differently."[6] However, having language to that effect as a statutory provision seems desirable, although the meaning of "whatever investigation is appropriate" will be determined only by litigation of individual cases.

3. Fraudulent act

   Sec. 234D. [*Fraudulent act.*] (a) [*General.*] "Fraudulent act" includes an act, device, scheme, practice, or course of conduct that (1) is fraudulent, (2) operates or would operate as a fraud, or (3) is likely to deceive regardless of whether deception is intended.

   (b) [*Inaction or silence.*] Inaction or silence when there is a duty to act or speak may be a fraudulent act.

This definition introduces a note of uncertainty into the code. "Misrepresentation" seems adequately defined, but the definition of "fraudulent act" is circular at best. Problems caused by the inadequacy of the definition are discussed later in this chapter.

Prohibitions

Part XIII of the code, "Fraudulent and Manipulative Acts," specifies prohibitions. Part XIV imposes liability for violation of the prohibitions. Most of the sections in part XIII begin "It is unlawful. . . ."

> Sec. 1301. [*Purchases, sales, proxy solicitations, tender requests, and investment advice.*] (a) [*General.*] It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with (1) a sale or purchase of a security, an offer to buy or sell a security, or an inducement to hold a security. . . .[7]

Section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 limit the prohibitions to acts "in connection with the purchase or sale of any security." The question of whether section 10(b) and rule 10b-5 encompass "an inducement to hold" has been the subject of considerable litigation. The most recent case, *Blue Chip Stamps* v. *Manor*

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6. Reporter's comment to section 234A of *Tentative Draft no. 2* (1973).
7. Similar language in section 1304(a) and (c) prohibits fraudulent acts or misrepresentations in filings pursuant to the code and in press releases or other forms of publicity.

Drug Stores, decided by the Supreme Court in 1975, limited the plaintiff class in private damage suits under those provisions to actual purchasers and sellers of securities. Section 1301(a) appears on the surface to contradict that ruling. However, a comment by the Reporter to section 1301(a) in *Tentative Draft no. 2* indicates that the phrase "inducement to hold" contemplates an affirmative act, presumably more than expressing an unqualified opinion on misleading financial statements. In the absence of an affirmative act, part XIV would not give a private right of action to mere holders.

Section 1301(a) prohibits both fraudulent acts and misrepresentations, but, as previously noted, an adequate definition of fraudulent acts is not given.

> Section 1301(b). [*Purchases, sales, proxy solicitations, tender requests and investment advice.*] [*Duty to correct.*] It is unlawful for any person to fail to correct a statement of a material fact that was made by him or on his behalf in a communication with respect to a matter within section 1301(a), and that becomes a misrepresentation by reason of a subsequent event. . .
>
> Section 1304. [*False filings, records, and publicity.*] (d) [*Duty to correct.*] It is unlawful for any person to fail to correct a statement of a material fact that was made by him or on his behalf in a filing, record, document, or form of publicity specified in this section, if a correction is necessary to disclose a fact of special significance within the meaning of section 1303(c) that is the result of a subsequent event and is not generally available within the meaning of section 1303(d), unless (1) the filing, record, document, or form of publicity is not reasonably current . . . or (2) the person makes a reasonable effort under the circumstances to correct the statement.[8]

Similar language presently appears only in rule 14a-9(a) concerning proxies. Section 1301(b) explicitly broadens the rule to cover the dissemination of information affecting market transactions, although both the SEC and the courts have found that auditors already have a duty to disclose subsequently discovered errors in financial statements. Sec-

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8. Sections 1303(c) and (d), referred to in section 1304(d), read as follows:

   (c). [*"Fact of special significance."*] A fact is "of special significance" if (1) in addition to being material it would be likely on being made generally available to affect the market price of a security to a significant extent, or (2) a reasonable person would attach special importance to it in determining his course of action in the light of such factors as the degree of its specificity, the extent of its difference from information generally available previously, and its nature and reliability.

   (d). [*"Generally available."*] A fact is "generally available" when (1) it is disclosed in a filing or is otherwise disclosed by means of a press release or other form of publicity reasonably designed to bring the fact to the attention of the investing public, and (2) one week or any other period that the Commission prescribes by rule has expired since the filing or other disclosure. When these conditions are not satisfied, the burden of proving that a fact is generally available is on the person who so asserts.

tions 1301(b) and 1304(d) could, depending on their interpretation by the courts, extend that duty.

Present auditing standards[9] describe the auditor's responsibilities on his discovery subsequent to the date of his report of facts existing at that date that might have affected his report had he been aware of them. There is no specific responsibility for other types of subsequent events after the auditor has reported. For example, a loss on receivables resulting from a customer's major casualty after the issuance of the financial statements would not require a correction of those statements or a change in the auditor's opinion. Whether this would continue to be the case under section 1301(b) is unclear.

Civil Consequences of Violations

Part XIV of the code, "Civil Liability," specifies the civil consequences of violations of part XIII.

> Sec. 1403. [*False registration statements, offering statements, and annual reports.*] (a) [*Scope of section.*] This section applies . . . on proof that an effective registration statement, an effective offering statement . . . , an annual report filed with the Commission . . . or any other report so filed and incorporated by reference in any such filing (1) contained a misrepresentation, (2) omitted (or failed to incorporate by reference) a material fact or document required to be included (or incorporated by reference), or (3) was not corrected as required by section 1304(d); but this section does not apply to an annual report to security holders except to the extent that it is incorporated by reference in, or reflects a misrepresentation or omission in (or failure to correct), a filing otherwise covered by this section.
>
> (b) [*Defendants.*] The following persons are liable for damages under this section: . . . (5) every expert whose consent has been filed . . . (but only with respect to statements that purport to have been made by him). . . .
>
> (c) [*Plaintiffs.*] This section gives a right of action to a person who proves (1) that, in the case of an offering statement, he bought a security of a class covered thereby after its effectiveness, or
>
> (2) that, in the case of a registration statement or report, he bought or sold a security of the registrant after the effectiveness of the registration statement or the filing of the report. . . .
>
> (f) [*Defense based on defendants' conduct.*] . . . [The auditor] has a defense that . . . (3) . . . he had, after reasonable investigation, reasonable ground so to believe and did so believe. . . .
>
> (g) [*Standard of reasonableness.*] In determining what constitutes reasonable investigation or care and reasonable ground for belief under section 1403(f) (3), the standard of reasonableness is that required of a prudent man under the circumstances. . . .

9. Statement on Auditing Standards no. 1, section 561.

In consolidating the several securities acts, the code eliminates many of the present differences between the 1933 and 1934 acts in the standard of care required of auditors. The standard of care required by section 1403 (applicable to registration statements, offering statements, and annual reports filed with the SEC) is essentially that of the present 1933 act.[10] This would impose liability on auditors for negligence, without regard to a privity standard, for annual reports and registration statements that presently fall within the purview of the 1934 act (including section 18, section 10(b), and rule 10b-5) as well as for offering statements that are presently covered by the 1933 act. This represents no change from the standard of care presently required by the 1933 act, but it significantly increases the standard under sections 18(a) and 10(b) of the present 1934 act, both of which require scienter to support a private right of action. However, as discussed below, the effect of this expanded liability would be offset in part by a limitation of damages.

Limitation of Damages

Sec. 1402 (f). [*Measure of damages.*] (1) The measure of damages . . . is

(A), if the plaintiff is a buyer, the difference between the amount that he paid and the value of the security determined as of the time specified [in other sections of the act] . . .

(B), if the plaintiff is a seller, the difference between the amount that he received and the value of the security determined as of the time specified [in other sections of the act] . . .

(2) . . . the measure of damages as specified in paragraph (1) is

(a) reduced to the extent (which may be complete) that the defendant proves that the violation did not cause the loss . . . .

Sec. 1403 (h). [*Measure of damages.*] The measure of damages is that specified in section 1402(f) (1) and (2) (a), except that

(1) in an action involving an offering statement or amendment

(a) the measure of damages is limited . . . by the amount of the securities sold thereunder, [and]

(B) the price paid may not be taken to exceed the public offering price . . . , and

(2) the measure of damages, with respect to a particular filing (or with respect to substantially the same misrepresentation or omission reflected in more than one filing), is limited with respect to each defendant (after

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10. Section 11(c) of the 1933 act specifies that the standard of reasonableness is that "required of a prudent man in the management of his own property." The code proposes a lower standard than the 1933 act, but the requirements for determining reasonableness in the 1933 act have never been literally applied to accountants. In the *BarChris* case the judge stated that "accountants should not be held to a standard higher than that recognized in their profession." He did not, as he did in the case of other defendants, refer to the standard of reasonableness stated in section 11(c).

application of section 1402(f) (2) (A) and the inclusion of any costs assessed under section 1418(d), but apart from interest) to the greatest of

(A) $100,000, [or]

(B) one percent (to a maximum of $1,000,000) of gross revenues in the defendant's last fiscal year before the filing of the action . . . ; but this paragraph does not apply if the plaintiff proves a misrepresentation made with knowledge by the particular defendant. . . .

The limitation of damages in section 1403(h) (2) applies to both present 1933 and 1934 act filings. It clearly represents a trade-off for the extension of liability for negligence to what are now 1934 act filings, an extension that denies to the profession many of the benefits of the *Hochfelder* decision. The limitation is significant, since suits against auditors have been settled in amounts well over $1 million.[11]

The limitation does not apply to a "misrepresentation made with knowledge." As noted earlier, it is harder for a plaintiff to establish knowledge than to establish scienter, as defined in clauses (b) and (c) of section 296AA. This higher standard of proof should give the profession some comfort.

However, the particular language used (or the absence of appropriate language) leaves room for uncertainty as to the effect of section 1403. The section removes the limitation of damages from *misrepresentations* made with knowledge. It is silent as to *fraudulent acts.* In fact, section 1403 is couched essentially in terms of misrepresentation. The term *fraudulent acts* does not appear. But the intent of part XIV generally is to impose liability for violations of part XII, and section 1301(a) prohibits both misrepresentations and fraudulent acts. Thus, "fraudulent acts" are not discussed in connection with the limitation of damages. Moreover, as noted earlier in this chapter, the prohibited "fraudulent acts" are not adequately defined.

The auditor's liability for a misrepresentation and the limitation of damages for a misrepresentation can be tracked through the code. A similar tracking is not possible for a fraudulent act. Consequently, this introduces a further note of uncertainty into the value of the trade-off in the code.

Sec. 1417. [*Nonexclusivity of part XIV.*] (a) [*Implied actions.*] A court may recognize a private action based on a violation of a provision of this Code . . . even though it is not expressly created by part XIV. . . .

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11. The Reporter's comments make clear that "an accounting . . . firm is a single defendant, whether organized as a corporation or as a partnership" (Reporter's comments to section 1403(g) of *Tentative Draft no. 2* (1973)). However, the Reporter's comments are just that—comments. The comments may be considered by a court in applying the code to a particular case, but there is no requirement that it do so. Moreover, all individuals who participated in a violation of part XIII could also be individually liable, since under common law an individual is responsible for his own torts.

Under this section, private actions under present rule 10b-5 receive formal statutory recognition. The section incorporates the limitation of damages discussed above. Whether the section would expose auditors to greater liability cannot be determined without resolution of the uncertainties previously discussed surrounding the meaning of "fraudulent acts" and the current requirements to establish liability under section 10(b) and rule 10b-5. Section 1417 will undoubtedly be reconsidered in the light of *Hochfelder* and subsequent court interpretations.

> Sec. 1418. [*Relief available.*] (a) [*Consequential damages.*] (1) Nothing in this Code . . . precludes the award, in addition to rescission when appropriate or the appropriate measure of damages, of any incidental or consequential damages resulting from the conduct that is the basis of the action.

The effect of this section is not clear. It could be an exception to the code's limitation of damages that might emasculate the general principle.

Assessment of Costs

> Sec. 1418(d). [*Costs: general.*] In a private action created by or based on a violation of this Code . . . , the court, on a finding of bad faith or lack of merit in the action or defenses (as the case may be), may (1) assess reasonable costs (including reasonable attorney's fees) against any party, and (2) require any party at any time to give an undertaking for the payment of such costs.

Section 1418(d) permits the award of attorney's fees to the prevailing party, including the defendant. It also permits the court to require an "undertaking" of any party, that is, a bond to cover the other party's attorney's fees. Section 11(e) of the 1933 act and sections 9 and 18 of the 1934 act allow filing for an undertaking; section 10(b) and rule 10b-5 do not.[12]

This section should have the effect of discouraging frivolous or nuisance suits. Permitting an undertaking and allowing the award of attorney's fees to the defendant auditor in all private claims under the code would discourage nuisance suits. It is also a necessary part of the trade-off for the code's extension of liability for negligence to all filings.

Imposing defense costs on the *plaintiff* may not be a sufficient deterrent to nuisance suits. Defendant auditors and their attorneys believe that the source of nuisance suits is not the plaintiff, but rather his attorney. Penalizing attorneys who bring ill-founded actions has

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12. In the *Hochfelder* opinion, the Supreme Court stated that the district court's power to award attorney's fees is "sharply circumscribed" in 10(b) cases. Liggio points out the court did not use the word "prohibited" (1976, p. 1).

been suggested as the only means of preventing nuisance suits, and this the code does not do.[13]

Liability as Aiders and Abettors

> Sec. 1419. [*Persons liable.*] (b) [*Aiders and abettors*] (1) An agent or other person who causes, commands, induces, procures, or gives substantial assistance to conduct by another person (herein a "principal") giving rise to liability under this Code . . . with knowledge that that conduct is the kind specified . . . is liable to the same extent as the principal.
>
> (2) A person is not liable under section 1419(b) (1) for a misrepresentation by a principal that is actionable under section 1404, 1405(b), 1406, or 1407 unless there is proof of the person's scienter as to the misrepresentation.
>
> (3) For purposes of any limitation of liability applicable to each defendant, a director, officer, or employee of a company is considered to be a separate defendant from the company only if he is liable under section 1403(b) or the foregoing portion of this subsection.

Auditors are frequently drawn into private litigation as alleged aiders and abettors. Whether liability exists for negligent aiding and abetting, or whether scienter or knowledge must be proved, is presently an open question. "Most securities law aiding and abetting or conspiracy cases have not discussed the knowledge point because knowledge was not in question" (Ruder, 1972, p. 632). The Supreme Court in *Hochfelder* left open whether scienter (as defined by the Court) was necessary for liability as an aider and abettor.

In its most current draft to date, the code sets a knowledge requirement for liability as an aider and abettor under some sections and sets a scienter requirement for such liability under other sections. This distinction, which does not appear logical, may well be eliminated in future drafts. A knowledge requirement for aiding and abetting seems appropriate, given that the limitation of damages discussed earlier does not apply when a misrepresentation is made with knowledge. In that regard, section 1419 (b)(3) is also significant in that each aider and abettor is considered a separate defendant for purposes of any limitation of liability.

Statute of Limitations

> Sec. 1422. [*Statute of Limitations.*] (a) [*Filing requirements, etc.*] No action under section 1401 or 1411 may be brought more than one year after the date of the last act constituting the violation or other conduct on which the action is based . . .
>
> (b) [*Fraudulent acts, etc.*] No action . . . may be brought more than (1) one year after the plaintiff acquired knowledge, or by the exercise of reason-

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13. See the discussion in chapter 3 on the courts' power to discipline lawyers under rule 11 of the Federal Rules of Civil Procedure.

> able diligence should have acquired knowledge, of the underlying facts, or (2) five years after the last act constituting (A) the violation or other conduct on which the action is based . . . , or (B) the plaintiff's purchase or sale . . .

This section provides for a uniform statute of limitations. The present securities acts do provide absolute cutoffs for express actions permitted under the acts. However, most civil litigation that now takes place does so under the implied provisions of rule 10b-5. In rule 10b-5 cases, the courts presently apply the statute of limitations in the jurisdiction where the suit is brought, and this varies from state to state.[14]

Reliance and Causation

Conspicuous by its absence in part XIV of the code is the concept of reliance.

> The basic approach of this draft is to eschew reliance as such with one or two exceptions . . . in favor of a "lack of knowledge" test when it is appropriate . . . and to define cause in the legal sense, but to follow the lead of Sec. Act. section 11(e) in adjusting the burden of proof. . . . Since causation is traditionally contemplated in terms of damage caused by *reliance* on tortious conduct, reliance may inevitably be implicit to a degree in those provisions that refer to "any loss caused by the violation." But (with the stated exceptions) reliance does not figure as a separate element. . . .
>
> Because so many components affect the market in a given security, and they are so hard to isolate, and by hypothesis the plaintiff has proved wrongdoing on the part of the defendant by the time the causation point is reached, those sections that create liability by buyers or sellers in connection with false filings or publicity, deceptive sales or purchases, and manipulative acts follow the lead of Sec. Act section 11(e) by shifting the burden to the defendant to show either partial or complete *lack* of causation. . . .[15]

Section 215A defines "caused" as follows:

> A loss is "caused" by specified conduct to the extent that the conduct (a) was a substantial factor in producing the loss and (b) might reasonably have expected to result in loss of the kind suffered.

As noted in chapter 3, the questions of reliance and causation have received considerable attention by the courts, much of it after the consideration that led to *Tentative Draft no. 2*. Consequently, the elimination of the reliance concept will probably be reexamined.

Administration and Enforcement

Part XV, "Administration and Enforcement," brings together in one place the SEC's present authority over auditors. Section 1503 pre-

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14. Reporter's note to section 1422 of *Text of Tentative Drafts nos. 1-3* (1974).
15. Reporter's comment to section 215A of *Tentative Draft no. 2* (1973).

serves, but does not extend, the SEC's authority to

> (1) define accounting terms, (2) prescribe the form and content of financial statements and the accounting principles and standards used in their preparation, (3) require the examination of and reporting on financial statements by independent public accountants, (4) establish standards of independence for public accountants insofar as they practice before it, and (5) prescribe the form and content of the independent public accountant's report.

A comment to section 1503 in *Tentative Draft no. 3* by the Reporter notes that

> after a considerable amount of discussion centering primarily around the Commission's role with respect to the auditing process, there is reason to anticipate that the language of section 1503 as a whole will prove to be agreeable to both the SEC and the AICPA.
>
> This draft of section 1503 is advanced on the assumption (1) that nothing in it is designed to subtract from the authority (express or implied) that the Commission has . . . , or to change the basic relationship between the Commission and the accounting profession, and (2) that [the section] necessarily subsumes a degree of authority with respect to the scope (or standards) of, and procedures to be followed in, audit examinations.

Section 1513(e) provides that a hearing in an adjudicatory proceeding (that is, a rule 2(e) administrative proceeding under the current statutes) "shall be public when all the respondents so request." However, "in the absence of such a request, the hearing . . . shall be private or public as the Commission determines by rule or order." This does not represent a change from the present authority of the SEC.

Section 1515(a) provides that

> the Commission may bring an action to enjoin a violation of, or to enforce compliance with this Code. On a showing that the defendant has engaged, is engaged, or is about to engage in acts or practices constituting such a violation, and that there is a reasonable likelihood that he will again engage, or will continue to engage, in such acts or practices unless enjoined, the court shall grant appropriate relief in the form of temporary or permanent restraining orders and injunctions and orders enforcing compliance.

Section 1517 provides for criminal penalties for "a person who violates with scienter a provision of this Code involving a misrepresentation, or who intentionally or recklessly violates" other provisions of the code. This creates a lesser standard of proof (scienter) in criminal prosecutions than that required (knowledge) in civil actions in which a recovery beyond the code's monetary limitation is sought. However, the standards for criminal liability will be determined by the proposed revision of the Federal Criminal Code rather than by the Federal Securities Code.

6

Effects of the Legal Environment on Professional Practice

The present legal environment has had consequences that affect both the auditing profession as a whole and the practice of individual auditors and firms. This chapter develops a framework for evaluating those consequences and then examines some of the specific consequences. The basic issue is: How has the present legal environment affected the efficiency and effectiveness of the audit function? The question will be considered from the viewpoint of society, the profession, and the individual auditor or firm.

A Framework for Evaluating the Effects

Davidson stated that role "is determined by the interactions of the expectations of the various individuals and groups having an identifiable relationship to the role position. . . . Formal and/or informal rewards and sanctions are used to assure conformity to role expectations. . . . Failure to conform to the ascribed role or to meet role expectations creates the risk of social action to enforce conformity and to penalize nonconformity" (1975, pp. 2-5). Clearly, the existing legal environment encompasses many of the sanctions that assure conformity to role expectations. The significant question is whether present legal sanctions provide the most efficient way of assuring the auditor's conformity. If the existing legal sanctions do not adequately reflect society's expectations, they can be changed through legislation. The paucity of legislation nullifying court decisions suggests that the courts have correctly perceived those expectations, although the complexities of the process could also explain the legislative inactivity.

Are society's expectations realistic? Can auditors achieve them? If auditors cannot, society will either have to revise its expectations or the expectations will be met by another group (Davidson, 1975, p. 2). A revision of expectations requires an educational effort by those wishing to change the expectations, and this would surely have to be a significant part of any effort to change the legal climate.

The assumption of a particular role entails both costs and benefits to society. Some of the costs are the result of both civil and administrative litigation, but those costs are *not* measured by the payments by auditors and their insurance carriers to plaintiffs and their attorneys. The real costs to society are opportunity costs, that is, the benefits that society may be losing if the auditor becomes economically inefficient, for example by performing unnecessary work.

To look merely at the amount of settlements as a measure of costs ignores the point that the settlements are only transfer payments within society. Those payments do, however, result in a redistribution of wealth, and consequently may have derivative effects. The redistribution is not easy to determine. For example, if damage payments to investors were ultimately borne by investors through higher audit fees and lower dividends, all that would occur would be a redistribution of wealth within the investor group. However, this redistribution and investor awareness of it is probably necessary to support the capital formation process, which would be diminished without the ability to obtain redress for illegal acts in connection with the purchase and sale of securities.

This analysis is not intended to suggest either that there is no cost to auditors or that there are no further effects on society from the redistributive process. An auditing firm probably cannot shift all the litigation and insurance costs to the client in the form of higher fees. The competitive nature of public accounting practice would prevent that. Some of the litigation and insurance costs will undoubtedly be absorbed by the firm. That would result in lower incomes of partners and staff or economies in recruiting, training, and other quality control policies and procedures that would not be in the public interest and might be the cause of future litigation. The analysis merely suggests that to look at the number of legal cases and the amounts involved is not the best way to measure social costs and social benefits that arise from society's having thrust the auditor into a particular role.

Some idea of the redistribution effects of settlement costs can be derived from the following estimates.[1]

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1. Data developed from nonpublic sources.

Cost		Percentage of total
Awards to plaintiffs		33
Attorneys' fees:		
Defense	14	
Insurance company	2	
Plaintiff	17	33
Underwriting fees		4
Lost time and inside defense costs		30
Total		100

The total represents the litigation cost to the public accounting firm and assumes that the insurance company breaks even. Presumably, it is that total that either is included in audit fees and thereby passed to clients or is borne by the firms. The estimates indicate that for each dollar awarded to injured investor plaintiffs, the investor public as a whole pays three dollars. The efficiency of litigation as a determinant of the auditor's role or as a means of providing redress is therefore highly questionable. Most other forms of insurance protection are designed to achieve a preponderance of recoveries as opposed to "handling" costs. Thus, a major effect of litigation against auditors might well be a redistribution of wealth from investors to attorneys and auditors. However, this conclusion results from what can be described at best as a simplistic model. The redistributive effects are undoubtedly more complex.

For example, insurance carriers may not be able, particularly in the short run, to recover an unusually large loss through higher premium charges to either the insured itself or other firms in the same profession. The loss may be spread even more broadly through increased premiums over a wide range of excess liability policies covering many professions or industries. This, in turn, would affect costs and prices over a broader range of economic activity than the public accounting profession alone. Alternatively, carriers of excess liability insurance may simply withdraw from the market when faced with unpredictable large losses.

Olson noted the effect of recent litigation on the insurance market:

> In summary, *Hochfelder* will help. But it is not a panacea for the growing problem of class action plaintiff's counsel seeking to pick the "deep" pockets of independent accountants. Indeed, one major adverse development has materialized since the Supreme Court decision in *Hochfelder*. The professional indemnity insurance situation deteriorated dramatically in two ways. The cost of primary coverage became prohibitive. One major firm with a very good record is known to have concluded that it could not economically afford to have any insurance for the first $3 million of any claim and has recently dropped its primary professional indemnity insurance coverage. Equally disturbing, it also found that it was simply unable to renew over 25% of its catastrophe (excess) coverage.

Other firms are also believed to have found primary coverage prohibitively expensive, and to have lost a significant portion of their catastrophe coverage. While some may believe that those writing professional indemnity insurance overreacted to adverse developments of the last few years, that is, of course, difficult to prove with hard evidence. [Olson, 1976]

In brief, the analysis in this chapter is directed to the following issues:

- How has the changed legal climate affected the performance of individual auditors and firms?
- How has the changed legal climate affected other aspects of the environment in which an auditor works, and what have been the effects of those derivative changes on audit performance and role?
- Does the auditor's view of his present role as it has been affected by the changed legal climate lead to the most efficient use of economic resources? Is society getting the most benefits from the audit function at the lowest cost? Could a changed role definition increase the benefits or lower the costs to society?

Unfortunately, in the absence of both a control group and measurement criteria, it is difficult to separate the changes in the profession that have resulted from a litigious environment from those that have resulted from other variables such as the increasing complexity of financial transactions, technological developments, and the growth of multinational enterprises. Only a minor act of faith is needed, however, to recognize at least some causation between the effects that are described below and the growth in litigation over the last decade. If the legal environment has in fact produced effects that are suboptimal for society, changes in the legal environment should be explored. That will be discussed in chapter 7.

Benefits to Society

The litigious environment has encouraged the public accounting profession and firms to reexamine and strengthen auditing standards and methods of encouraging compliance with them. In recent years, the AICPA has issued many authoritative auditing pronouncements and revised its code of professional ethics. The Institute has devoted considerable attention to the design and implementation of quality control reviews of firms. Individual firms have also devoted more resources to their own policies and procedures for maintaining and raising the quality of practice.

Increased Activity of Authoritative Auditing Bodies

From 1965 through 1976, the Auditing Standards Executive Committee and its predecessor, the Committee on Auditing Procedure, issued thirty-five statements. (This excludes Statement on Auditing Standards no. 1, which was a codification of previously issued statements.) The activity of the committee accelerated in recent years, as the following data show.

Year	Number of Authoritative Auditing Pronouncements
1965	2
1966	2
1967	2
1968	1
1969	1
1970	2
1971	7
1972	4
1973	0 (plus SAS no. 1)
1974	3
1975	7
1976	4
	35

At least on the surface, a relationship between the committee's annual activity and the increased litigation and SEC activism of recent years is present. It is difficult to ascertain whether the level of committee activity and the "quality" of its work would have been greater or lesser in the absence of litigation. To the extent that auditing statements clarify existing responsibilities, litigation may be assumed to provide an impetus to a greater number of pronouncements. However, both the profession and society may have suffered from either the content or the quality of the pronouncements. That possibility is considered later in this chapter.[2]

2. This study does not explore the effect of litigation on authoritative accounting (as contrasted with auditing) bodies. There has been an increased level of activity in the accounting as well as in the auditing area, and the profession has taken various procedural steps to enable authoritative accounting bodies to maintain or even increase that level of activity. However, the increased activity and improved procedures are the result of numerous influences, and it is difficult to find specific evidence to link the level of activity of the Committee on Accounting Procedure, the Accounting Principles Board, and the Financial Accounting Standards Board, or the content of their pronouncements, to either specific litigation or the increased level of litigation.

Increased Attention to Quality Control

Both the profession and individual firms have considered the need for more effective controls over the quality of audit practice. Statement on Auditing Standards no. 4, *Quality Control Considerations for a Firm of Independent Auditors*, published in 1974, gave authoritative recognition to the need for quality control policies and procedures. The AICPA and state societies of CPAs have encouraged compliance with professional standards through such devices as the AICPA practice review program, mandated continuing education in several jurisdictions, the AICPA local firm quality review program, the AICPA local firm administrative review program, and the AICPA voluntary quality control review program for CPA firms.

Individual firms have also designed and implemented programs for monitoring practices. Evidence that supports an expanded activity by CPA firms in this area includes, among other things,

- Increased resources devoted to continuing education.
- Institution of second-partner and interoffice review of work papers and reports.
- Practice bulletins directed at both accounting and auditing issues.
- Policy statements on internal quality control programs.
- Institution of both voluntary and mandatory peer reviews.
- Engagement of other auditing firms to conduct independent quality reviews.

The available evidence does not indicate the extent to which these attempts to maintain or raise the quality of professional practice are in fact successful. Formal research to measure how the quality of practice has increased in the past decade is impractical. In particular, drawing inferences about the quality of practice from data on the volume of litigation is dangerous. As has been suggested regarding the medical profession, it may be the more highly skilled auditor who undertakes the riskier audits and thereby exposes himself to civil, criminal, and administrative proceedings.[3]

No empirical evidence exists that would indicate the extent to which any apparent or real increase in the quality of practice is

3. A recent study of medical malpractice claims indicated a "prevalence of claims among highly trained, certified specialists, particularly those practicing in a hospital setting." "Highly Trained Called Targets of Malpractice Claims," *New York Times*, May 10, 1976, p. 23.

causally related specifically to the litigious environment. Logically, the link should be present. Mautz argued that a litigious environment should serve as an impetus to a high level of performance:

> An accountant accused of improper conduct will be judged by the standards of the time in which his "case comes to court" rather than by the standards in effect when the engagement at issue was completed. This fact alone should urge accounting firms and practitioners to reconsider their quality control procedures and to keep their personal standards of performance as high as they can. [1975, pp. 50-51]

Sommer cited the second-partner review procedure as resulting directly from litigation:

> It is reported that, as a consequence of the *Simon* decision, several auditing firms have instituted a procedure whereby a partner not involved in the audit, as one of the final steps before release of the opinion, steps back and considers the financials as a whole in terms of their understandability. [1974, p. 24]

To the extent that the quality of professional practice has responded to private litigation and SEC enforcement, the existing legal climate may not be the most efficient way of attaining a specified level of auditor performance. Also, the present level of auditor performance may not be commensurate with the benefits and costs to society. Individual auditors and firms may well reach an optimum level of performance that maximizes their private benefits given the revenue and cost functions they face, with litigation expense included in the cost function. But that does not necessarily ensure an optimum level of performance from the viewpoint of society. Society "pays" for the level of the auditor's performance in terms of foregone opportunities for alternative use of its resources, but no model exists that is useful in determining whether a given allocation of resources is in fact optimal.

Furthermore, the fear of civil and criminal liability and SEC enforcement programs may not continue to have the same salutory influence on the profession in the future. The level of fear may at some point exceed the room for improvement. The profession may have reached a stage of maturity in meeting its responsibilities that would be threatened and eroded by further escalation of risks facing the profession.

Costs to Society

Society may have suffered several potentially undesirable effects as a result of the existing legal climate. Those effects may add indirect costs that are borne by society to the direct costs associated with litigation such as legal and other defense costs. Some of those effects are more in the nature of reduced social benefits attributable to the legal environment. All have the potential of causing a misallocation of resources. The existence or significance of undesirable effects cannot be verified without empirical investigation and a benefit-cost model. The strength of the evidence lies largely in the experience and stature of those who have alleged the undesirable effects.

Auditor Reluctance to Meet Existing Responsibilities

Mautz and Sharaf suggested that, particularly in the area of fraud detection and prevention, fear of litigation has led to attempts by auditors to minimize their responsibility, with attendant undesirable consequences to both the profession and society.

> As important as minimization of responsibility is to professional practitioners at a time when nuisance suits and similar litigation seem to flourish, additional considerations merit attention. Until recently there was substantial acceptance of the idea that an independent audit had as one of its principal purposes the detection and prevention of fraud and other irregularities. Currently we find considerable emphasis on elimination or at least minimization of this responsibility through audit-client agreements, letters, and statements in the professional literature. Whether such agreements and statements offer any real protection we are not qualified to state. Even if auditors can contract away their responsibility for this particular service, serious consideration should be given to the wisdom of so doing. The advantage is an immediate release from what may prove to be an onerous and burdensome responsibility. The disadvantages may far outweigh this. First, the auditor appears to be renouncing his right to an area in which he has competence and in which he can be of service; second, as a professional group auditors are in effect refusing to provide an effective service to the business community; third, auditors are emphasizing to clients and the world at large their unwillingness to accept responsibility, to provide a difficult but useful service, to attempt to cope on even a small scale with an evil force that blights business life in no unsubstantial degree. Such a position cannot but lessen the prestige of the profession, particularly in view of the fact that the service and the responsibility we now deny were, at one time, claimed rather forcefully. [1961, pp. 129-30]

Auditor Reluctance to Accept New Responsibilities or Expanded Role

Russell Palmer questioned whether

> the accounting profession may not be showing some reluctance to extend itself into new areas. In connection with two recent controversies—reporting on interim financial statements and reporting on forecasts—the profession chose to debate and discuss rather than actively experiment. True, there are some difficult technical issues in each of these areas, but I am concerned that we may be using the conceptual questions to shield us from possible additional exposure to liability. [1975, p. 62]

Palmer went on to suggest that as a consequence the public interest is not being served.

Added Costs for Marginal Companies

Reiling and Taussig noted that a characteristic common to litigation involving auditors is that the cases

> involve businesses which have failed. Clearly, as a matter of self-protection, an auditor must perform a more extensive investigation when he suspects financial difficulties. Unfortunately, evidence of business failure may be more apparent in retrospect than at the time of an audit. Nevertheless, the current cases indicate the wisdom of expanding an audit program for a company with declining earnings or weak credit.
>
> The accountant's dilemma in this area has implications for society at large. If it becomes commonplace for stockholders to sue the auditors of every failing company, those firms least able to pay will be hindered by above average audit costs. Additional barriers to competition will be introduced because the cost of raising money and doing business will be higher for marginal companies. [1970, p. 45]

Whether and to what extent the audit of a marginal company should be expanded are debatable issues. Faced with those uncertainties, auditors may begin to reject marginal companies as clients because of the greater business risk surrounding them. Since virtually all new ventures are "marginal" in terms of their eventual success, that development could lead to a general inability of new enterprises to obtain auditors. The inability of new ventures to obtain audits would introduce an additional barrier to competition that could interfere with the optimal allocation of resources.[4]

The evidence does not suggest that the problem is significant, at least not at the present. To the contrary, CPA firms seem highly competitive in seeking new or expanding enterprises as clients. If the problem does develop, solutions might be found in lesser levels of assurance that the auditor might give to marginal companies or the granting of a "safe harbor" in those cases.

Creation of Accounting Principles and Auditing Standards by the Courts

The question of whether compliance with generally accepted accounting principles and generally accepted auditing standards is an

4. Arthur Andersen & Co., in its March 31, 1973, *Annual Report*, stated one auditing firm's views: "In the United States many companies which by their very nature are developmental, promotional and of the venture capital type have gone to the public security markets for equity or debt capital. Our involvement with many companies of this type is initiated by clients or directors of clients of long standing. In a private enterprise system a substantial number of companies that begin as new ventures are likely to fail. We have no crystal ball to tell which will succeed and which will fail, but we do not believe it is in the public interest for auditing firms with established reputations to decline these engagements."

adequate defense for auditors has been explored extensively in the literature and in a background paper prepared for the Commission on Auditors' Responsibilities (Radoff, 1975) and is not considered here. Rather, this study is concerned with the extent to which the courts have ruled on the acceptability and application of accounting principles and auditing standards and the implications of those rulings.

Questions about the acceptability of specific accounting principles were not significant in court cases prior to 1940. Most of the early cases involved the auditor's liability for the inadequate performance of auditing procedures. Similar questions continue to arise in current litigation, but not to the exclusion of allegations of errors in the selection or application of accounting principles.

> Plaintiffs increasingly allege violations of generally accepted accounting principles, a marked departure from such classic cases as *Ultramares* and *McKesson & Robbins*, in which the decisions were based largely on auditing deficiencies. Judges and juries not only are finding deficiencies in the way auditors examine financial records, but also are making statements on accounting principles and the way in which they should be applied. [Reiling and Taussig, 1970, p. 41]

For example, in *Herzfeld*, the district court ruled that the disclosure for a receivable of doubtful collectibility was inadequate even though it may have been customary and therefore in conformity with generally accepted accounting principles. In two cases not involving auditors, *Gerstle* v. *Gamble-Skogmo, Inc.* (1973) and *SEC* v. *Bangor Punta Corp.* (1971), the court challenged the adequacy of generally accepted accounting principles with respect to current values that differed significantly from book values, an issue not then addressed by authoritative accounting bodies.

The concern here is the role of the courts in determining the appropriateness of accounting principles. Reiling and Taussig, for example, question "whether accounting guidelines which emerge from the judicial process will be as well conceived as those resulting from the careful method of review and public exposure developed over the years by the AICPA" (1970, p. 42).

> The authors believe that the development of accounting principles by judges and juries as a by-product of their disposition of a series of cases will not result in the most desirable formulation of guidelines for financial reporting. Present litigation typically involves unusual circumstances, which could prejudice a decision on general principles. For instance, in *Westec*, officers of the company have been found guilty on a number of criminal counts, including improper security transactions. The moral taint from these convictions might affect the Court's regard for the defendants and might prejudice its ruling on whether a pooling of interest fairly presented acquisitions by Westec. The authors believe that accounting procedures should be generalized from the experience of going concerns run by ethical managers, not failing companies run by wrongdoers. [Reiling and Taussig, 1970, p. 46]

Also, most of the situations dealt with the adequacy of disclosure in unusual circumstances. It would be unfortunate if accounting principles were to be generalized from them.

Fiflis noted that the courts have generally applied the standards of the profession in auditing areas other than those of communication and reporting, but have applied lay standards to questions of reporting (1975a, p. 80). (See the further discussion in chapter 7.) Even in this limited area, the establishment of auditing standards by the courts raises the same questions as are raised with the establishment of accounting principles by the courts.

Defensive Actions by Auditors

Allegations have been made that increased litigation has led to defensive actions. Three types of defensive actions may be distinguished. The first is the performance of audit procedures that have as their primary or sole purpose providing a defense in the event of subsequent litigation or SEC enforcement proceedings. An analogy in the medical profession is the alleged practice by doctors of performing extra or unnecessary tests or calling in consultants primarily to support their judgments in the event of subsequent malpractice litigation. The available evidence is insufficient to indicate whether this type of defensive auditing is a significant factor in auditing practice. One observer's impression was that auditors have not "been driven to 'defensive auditing'—in the sense of audit steps that are plainly useless or even harmful" (Andrews, 1975). Defensive auditing may be little more than appropriate documentation of audit procedures or more careful selection of items to be tested.

A second defensive action may be providing users with lower levels of assurance than would otherwise be appropriate to the audit work performed. This is analogous to the alleged unwillingness of medical doctors to use "more innovative approaches in solving patients' problems because of concern for the possible legal risks" (Palmer, 1975, p. 62). Palmer suggested that evidence for this could be found in an increasing number of qualified opinions, which he traced to the auditor's fear of possible future litigation.

A third defensive action is related to the auditor's reluctance, noted above, to accept new responsibilities. There is reluctance to give less than audit assurance to users of financial or other information. A willingness to accept new responsibilities, for example in reporting on interim financial information, may require a willingness to provide users with a lower level of assurance than would result from an audit. However, there is a fear that the lower level of assurance will be misunderstood and serve to stimulate litigation. This results in auditor insistence on a level of involvement that will permit audit assurance, but which is uneconomical given the needs of users, thereby resulting in "overauditing." Alternatively, the auditor may completely avoid involvement, another potentially suboptimal position.

Reiling and Taussig suggested that, as a result of the *BarChris* decision, heretofore unaudited interim period statements be audited and that "the auditor attest to such other data contained in the registration statement as is capable of being measured" (1970, p. 46). There is no doubt that such a stance will, as they suggested, provide underwriters with more due diligence protection and auditors with a means of avoiding "the difficult problem of articulating detailed standards for the statutorily implied S-1 review" (Reiling and Taussig, 1970, p. 46). But it is far from certain that this would provide prospectus readers with more useful information, as is also alleged.

Difficulty in Hiring and Retaining Qualified Personnel

Mautz suggested that excessive litigation, with presumably the possibility of financial ruin, could discourage the most able from entering or continuing in the profession (1975, p. 53). College students, reading of the profession's legal problems, may be unlikely to be attracted to the profession. Staff auditors may move to alternative careers where their personal assets are less at risk. Even partners may seek early retirement or alternative careers. At a time when increased responsibilities are being thrust on auditors, those responsibilities may be met by less qualified practitioners. This would lead to more mistakes, more litigation, and more adverse publicity.

Only anecdotal evidence exists to support these contentions. Partners and staff leaving a public accounting firm have cited potential exposure to liability and the "cookbook" and "rulebook" nature of auditing practice that allegedly has resulted from the litigious environment as reasons for their decision. Students at times do inquire about a firm's past and current litigation. However, no hard evidence suggests that the problem is significant. Some might even conclude that the profession's stature has been enhanced by the auditor's position in the legal limelight.

Defensiveness by Authoritative Auditing Bodies

The possibility of a relationship between the extent of litigation and the quality of official auditing pronouncements was suggested earlier in this chapter.

Content of Authoritative Pronouncements. Fifty-four Statements on Auditing Procedure were issued between 1939 and 1972; fifteen Statements on Auditing Standards were issued between 1973 and 1976. With few exceptions, those pronouncements can be described as attempts to clarify the auditor's existing responsibilities in an audit of annual financial statements. Only a small portion of the sixty-nine pronouncements could be related to extending the auditor's role. Official pronouncements have been issued to define the auditor's responsibility with regard to *Other Information in Documents Containing Audited Financial Statements* (SAS no. 8, 1975) and a *Limited Review of Interim Financial Information* (SAS no. 10, 1975), but in both cases the Auditing Standards Executive Committee was responding to pressure from the SEC. No statements have been issued in other areas that might involve an extension of responsibilities to include auditor association with, for example, forecasts, financial information not based on historical costs, reports on management performance, or social accounting reports.

Of the sixty-nine pronouncements (which included two codifications), nine can be traced to audit failures that led to litigation. Other pronouncements can be traced more indirectly to specific audit failures. Those case-related pronouncements and the related cases are as follows:

SAP no. 1 (October 1939): *Extensions of Auditing Procedure* (McKesson and Robbins)
SAP no. 27 (July 1957): *Long-form Reports* (C.I.T. Financial)
SAP no. 37 (September 1966): *Special Report: Public Warehouses–Controls and Auditing Procedures for Goods Held* (Allied Crude Oil)
SAP no. 41 (October 1969): *Subsequent Discovery of Facts Existing at the Date of Auditor's Report* (Yale Express)
SAP no. 45 (July 1971): *Using the Work and Reports of Other Auditors* (Atlantic Acceptance)
SAP no. 47 (September 1971): *Subsequent Events* (BarChris)
SAP no. 48 (October 1971): *Letters for Underwriters* (BarChris)
SAS no. 6 (July 1975): *Related Party Transactions* (Continental Vending and U.S. Financial)
SAS no. 7 (October 1975): *Communications Between Predecessor and Successor Auditor* (U.S. Financial)

Even this list does not indicate the full effect that the legal environment has had on the work of the auditing committee of the Institute. Other auditing pronouncements originated from accounting pronouncements that in turn can be traced to alleged misconduct of one kind or another that led to litigation. For example, the origin of SAP no. 44 (April 1971), *Reports Following a Pooling of Interest*, was Accounting Principles Board Opinion no. 16 (August 1970), *Business Combinations*. This in turn had its source in the deterioration of accounting principles evidenced at least in part by litigation, such as the *Westec* case, that raised questions of the propriety of the principles selected and applied to account for particular combinations.

Moreover, the sources of a number of pronouncements were previous pronouncements that required further refinement or clarification, with the original pronouncement traceable to litigation involving auditors. For example, the source of SAP no. 1 (October 1939), *Extensions of Auditing Procedure*, was, as previously noted, the *McKesson and Robbins* case. Several following pronouncements involved further clarification of the auditor's responsibility for confirming receivables or observing physical inventory counts, the extended procedures of SAP no. 1. These pronouncements are—

SAP no. 3 (February 1940): *Inventories and Receivables of Department Stores, Installment Houses, Chain Stores, and Other Retailers*
SAP no. 12 (October 1942): *Amendments to Extensions of Auditing Procedure*
SAP no. 14 (December 1942): *Confirmation of Public Utility Accounts Receivable*
SAP no. 16 (December 1972): *Case Studies on Inventories*
SAP no. 17 (December 1972): *Physical Inventories in Wartime*
SAP no. 18 (January 1943): *Confirmation of Receivables from the Government*
SAP no. 19 (November 1943): *Confirmation of Receivables (Positive and Negative Methods)*
SAP no. 26 (April 1956): *Reporting on Use of "Other Procedures"*
SAP no. 36 (August 1966): *Revision of "Extensions of Auditing Procedures" Relating to Inventories*

Once again, speculation on "what might have been" is largely futile. However, the auditing committees might have been more inclined to consider new areas of responsibility in a less litigious atmosphere. Even in the area of defining existing responsibilities, attention might have been directed elsewhere in the absence of litigation.

Defensiveness in Defining Existing Responsibilities. Several observers have suggested that the profession has been unwilling to define auditing standards rigorously because of the fear of providing a basis for additional litigation. This appears to have been particularly true with regard to the auditor's responsibility for the detection of fraud. Carmichael noted that "as the amount of litigation against auditors and the size of potential damages increased, auditors became more cautious about describing their responsibilities in authoritative pronouncements and CPA firm manuals" (1975, p. 12). Sommer also noted, in quoting John Carey (1969, p. 248), that the AICPA "has become increasingly aware that pronouncements and rules which encourage higher standards of performance might be used against its members unfairly in the courts" (1972, p. 27). However, if the profession defines auditing standards at a level below that which society considers appropriate, it may discourage a high level of performance by auditors and generate even more litigation.

Conclusion

The evidence presented in this chapter does not permit an assessment of the overall effect on society and the accounting profession of the legal environment in which the audit function is performed. Specifically, there is no firm evidence about the existence, on balance, of undesirable effects or the degree to which they might have resulted from a litigious climate. Since the effects are not quantifiable, there is no way to determine whether the overall effect of litigation has been good or bad.

However, the inability to make this assessment is itself significant. It suggests that, despite the views of many auditors, the present legal climate has not had an overwhelming negative effect on either the profession or society. Consequently, major revisions in the legal environment might not produce significant benefits to society or to the profession.

The absence of evidence indicating an overall negative effect, however, does not rule out the possibility of making specific improvements in the legal framework facing auditors. An evaluation of proposals to improve the legal environment requires only the ability to ascertain whether they would, on an individual basis, provide or enhance one or more desirable effects without creating equal or greater undesirable effects. The inability to assess the overall effects of the present system of adjudicating disputes between auditors and others does not reduce the ability to assess the effects of specific changes in the system. We need not know precisely where we are to know if a change in that position is for the better or for the worse.

7

Proposals for Changing the Legal Environment

Various proposals have been advanced for changing the legal environment in which the audit function is performed. The proposals fall into several categories:

1. Limitations to monetary damages for substandard performance.
2. Changing the legal process through which disputes involving auditors are adjudicated.
3. Changing the institutional framework in which audits are conducted, including the mechanism for professional regulation and discipline.

Limitations to Damages

Statutory Limitations to Damages

The potential liability of an expert (including an auditor) under section 11 of the Securities Act of 1933 is the entire offering price of the public offering. Class actions under section 10 and rule 10b-5 of the Securities Exchange Act of 1934 have sought damages equal to the decline in the market value of all of the outstanding shares of an issuer. Earle argued that the exposure is out of proportion to the audit fee for an engagement (1972, p. 228). He and others have suggested various forms of limitation to the monetary damages that could be recovered from auditors in litigation under the federal securities acts.

The arguments for a statutory limitation to damages are summarized as follows:

1. Society has accepted the concept of statutory limitations to damages in other areas. Examples include claim limitations under no-fault automobile insurance and in workmen's compensation cases (Hill, 1975, pp. 178-79; Duncan, 1974, p. 457).

2. A statutory limitation would be an appropriate response to increased litigation against professionals and the evolution of a higher standard of professional care. "As the trend towards a strict (i.e., absolute) liability environment continues, the quid pro quo of limitation seems to me appropriate and fair" (Duncan, 1974, p. 457). Several state legislatures have considered limitations on a doctor's liability.[1]

3. Other countries provide precedents for statutory limitations to the liability of professionals, and professionals generally are seeking an extension of this practice. West Germany has statutory limitations for accountants. The International Federation of Consulting Engineers has also advocated limitations for engineers.[2]

   Professional bodies throughout the world have, at national level, prepared submissions to their governments seeking authority to limit liability in one form or another. Submissions have been made by the accountancy profession to the Scottish Law Commission and to the Australian Attorney-General, and the New Zealand Society of Accountants has made submissions to the Attorney-General in New Zealand. Also, the International Federation of Consulting Engineers, with its headquarters in Switzerland, published a year ago the findings of a working Committee on Professional Liability entitled, *A Guideline for Consulting Engineers on Professional Liability*, and I am aware of urgent attention being given by consulting engineers in [New Zealand] to representations to members along the lines recommended in that publication. [Duncan, 1974, p. 451]

4. Sommer noted some sympathy at the SEC for a statutory limitation.

   The SEC is not unconcerned with the danger of excessive financial loss, for we recognize that an indigent profession, or one blighted with financial

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1. "On April 18, 1975, the *New York Times* reported that Indiana had passed legislation which (among other things): (1) sets a ceiling of $500,000 on all malpractice damage awards and $100,000 on a physician's individual liability; (2) creates a state-operated patient's compensation fund; (3) empowers a medical review panel to screen alleged malpractice suits" (Peat, Marwick, Mitchell, 1976, p. 94).
2. The representations with regard to West Germany and consulting engineers are found in Duncan, 1974, pp. 451, 456.

adversity, will need to reduce its exposure and thereby lessen the protection afforded investors. Several years ago the American Institute of Certified Public Accountants proposed an amendment to Section 11 of the 1933 act to limit the liability on the auditors on the theory that it was absurd to expose them to liability for the entire amount of the offering while each underwriter was responsible only for his participation. The Commission was not unsympathetic to this plea. [1972, p. 24]

Several alternatives have been proposed as a basis of limiting monetary damages:

1. The ALI proposal (which "does not apply if the plaintiff proves a misrepresentation made with knowledge by the particular defendant") for an arbitrary limitation of the greater of "$100,000 or one percent (to a maximum of $1,000,000) of gross revenues in the defendant's last fiscal year before the filing of the action."
2. An arbitrary percentage of the offering price in a 1933 act registration, such as the 5 percent suggested by Earle (1972, p. 228).[3]
3. A limitation related to the fees received from a particular client. Fiflis suggested that

> better tailoring of the lines of liability could be achieved, for example, by limiting liability to a multiple of the fee received by the auditor for the engagement in which the breach of duty occurred; or a multiple of fees received from the client during a particular period; or a multiple of gross revenues from all clients for a particular period.[4] [1975a, p. 113]

The manner of achieving equity among all parties is a major issue that any scheme for statutory limitation to damages must resolve. The Reporter's comments to the proposed Federal Securities Code provide the rationale for the ALI's limitation of damages:

> In the absence of arbitrary limits set by section 1403(h) (1), there would be no built-in governor of the amount of recovery with respect to a false *registration statement* or *annual report* as there is [in section 1403(h) (2)] in terms of the aggregate public offering price of the securities covered by an *offering statement*. But there must be some maximum, not only to prevent the possibility of utterly outlandish recoveries for material but nevertheless relatively insubstantial lapses, but also because of the illogic under the new scheme of things of imposing a *greater* potential liability with respect to registration statements and reports than with respect to offering statements.
>
> The other side of the coin is that, unless the potential liability is high enough to attract able lawyers who are willing to undertake class actions

3. Earle did not address specific limitations under 1934 act filings.
4. The third suggestion resembles the ALI proposal, except that the ALI's "multiple" is 1/100 of gross revenues, to a maximum of $1 million.

> on a contingency basis, there may not be any practical enforcement; for it would be unrealistic to rely solely on the Commission. . . .
>
> The answer suggested is basically an arbitrary maximum of $100,000 per defendant. And this is expressed so as to include costs, because the attorney's fees awarded . . . might otherwise add a substantial amount to the $100,000 figure that is arbitrarily selected as the fair ceiling for each defendant. *But the $100,000 figure is subject to a number of qualifications. . . .*
>
> So far as offering statements are concerned, [the section 1403(h)(2)] limitation has been made applicable also. . . [to experts] but not to underwriters, on the ground that the offering price ceiling available under [section 1403(h)(1)] *is apt to be extremely high.*[5]

The Fiflis alternative to the ALI proposal relates the amount for which the auditor is at risk to the compensation he receives for the audit. For many auditing firms, a $100,000 liability would be ruinous. For a large firm, a $1 million loss might be less significant; it might not cover even the audit fees from a particular client.

The plaintiff's bar can be expected to oppose any form of statutory limitation to liability, although this may be blunted in part by an expanded concept of liability. Any statutory limitation to liability must adequately protect the rights of plaintiffs and be adequate for the recovery of costs and a reasonable fee by plaintiffs' attorneys. The composition of the ALI project, especially participants who are law professors and likely to have a sympathetic appreciation of the need to compensate plaintiffs, probably provides the best assurance that plaintiffs' rights will be adequately considered in the code. Moreover, the ALI limitations to damages apply to each defendant, and an accounting firm would generally not be the sole defendant in litigation under the code.

Fiflis opposed the ALI's proposed limitation, but whether his opposition is based on principle or on the specific provisions of the proposed code is not clear (1975a, pp. 112-13). If the latter, the opposition may be based on his misreading of the ALI proposal.[6] In his view, a limitation to damages would be unjust to injured parties, and the specific ALI proposal would not treat all defendants equitably.

The ALI's limitation is part of an overall proposal that includes extending auditors' liability to acts that under the Securities Exchange Act of 1934 would at present comprise mere negligence and thus be beyond the reach of plaintiffs in civil litigation for monetary damages.

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5. Reporter's Comments to section 1403(g), *Tentative Draft no. 2* (1973).
6. Fiflis stated that an "auditor will, under the Code, be held to a limit of 100,000 dollars" (p. 112). The code provides that the limitation is the greatest of $100,000 *or* one percent (to a maximum of $1 million) of defendant's gross revenues.

This extension will deny to the profession the "benefits" of the lower standard of care permitted in some 1934 act cases by the *Hochfelder* decision and will raise the standard of care to essentially that of the 1933 act.[7]

The Court in *Hochfelder* noted the consequences of such an extension:

> We do note that the standard urged by [the plaintiffs] would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts. Last Term, in *Blue Chip Stamps* . . .the Court pertinently observed: "While much of the development of the law of deceit has been the elimination of artificial barriers to recovery on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good. In *Ultramares Corp.* v. *Touche* . . . Chief Judge Cardozo observed with respect to 'a liability in an indeterminate amount for an indeterminate time to an indeterminate class. . . . The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.' "

The Court's requirement for scienter explicitly rejected the SEC's contention that a reading of rule 10b-5 to support a private action against an accountant based upon negligent performance "is necessary to accomplish its purpose of protecting investors, who are victimized by conduct, whether negligent or intentional, which operates as a fraud and deceit upon them."[8] (The effect on investors, the SEC argued, is the same regardless of whether the conduct is negligent or intentional.)

The profession may view the imposition of a negligence standard under what are now 1934 act filings as too high a price to pay for a statutory limitation to damages, particularly in the euphoria of the *Hochfelder* decision. But in *Hochfelder*, the Supreme Court only interpreted past congressional intent. Congress will be asked by the ALI to consider again the standard of care appropriate to experts under the securities laws. However, Congress could also act before a full consideration of the ALI proposal to impose a negligence standard without

7. As noted earlier, however, the standard of reasonableness in the code is lowered from that "required of a prudent man in the management of his own property" in section 11(c) of the 1933 act to "that required of a prudent man under the circumstances." Although the language of the 1933 act has not been directly applied to accountants, it could be in a future case. Thus, the standard of reasonableness in the code is a further advantage to accountants.
8. *Brief for the Securities and Exchange Commission as Amicus Curiae Before the U.S. Supreme Court in Ernst & Ernst* v. *Hochfelder* (1976).

any trade-off in the form of damage limitations.[9] The evolution under common law noted earlier that has led to expanded responsibilities to third parties could easily be extended further by legislation.

Although the Court's interpretation of the 1934 act distinguishes between negligence and fraud, the public may not. Thus, the image of the profession and, hence, its credibility could well be enhanced by an acceptance of the highest possible standard of care, coupled with a limitation on monetary damages. The trade-off of limited monetary damages for a higher standard of care may permit the profession to meet user expectations regarding the level of care without imposing excessive monetary damages for a failure to meet those expectations.

Too many uncertainties, however, are involved to permit an evaluation at this time of the costs and benefits of the proposed code to both auditors and users. Among the uncertainties are

- The extent to which reckless behavior is sufficient for civil liability under rule 10b-5. For example, an indication by the Court that recklessness will not support a private action under rule 10b-5 would increase the value of what the profession would be giving up under the ALI proposal.
- The extent to which the ALI will revise its definition of "scienter" as a result of the *Hochfelder* decision and its specification of the degree of culpability that will render the limitation of damages inapplicable. Recent court decisions may have a significant effect on the redrafting of the code that is currently in progress.
- Estimates of the potential damages in fully litigated law suits and in settlements under the negligence standard of the proposed code. Research on the nature of claims brought against auditors

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9. The staff study, *The Accounting Establishment*, prepared by the Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations recommended that "Congress should amend the Federal securities laws to restore the right of damaged individuals to sue independent auditors for negligence under the fraud provisions of the securities laws. Such legislation is necessary to overturn the holding of the U.S. Supreme Court in *Ernst & Ernst* v. *Olga Hochfelder* . . . that 'scienter'—the intent to deceive, manipulate, or defraud—is a necessary requirement of private actions for damages under the fraud provisions of the securities laws. The dissenting justices recommended that Congress restore the rights denied individuals in order to achieve the remedial intent of the Federal securities laws.

"The few independent auditors who perform negligently should be held responsible for their actions, and should not be permitted to impair public confidence in the competence of all independent auditors. The Federal Government should not establish any 'accountant-client privilege' or provisions which would limit the liability of independent auditors. Competent independent auditors already are adequateiy safeguarded, and unnecessary restrictions would impede the operations of Federal enforcement authorities and courts of law." U.S. Senate, Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations, *The Accounting Establishment: A Staff Study* (Washington, D.C.: U.S. Government Printing Office, 1976).

before *Hochfelder* for negligence is needed as a basis for estimating the potential for similar claims under the code.

- The extent to which litigation in state courts under common law will increase as a result of the standards set by *Hochfelder*. The ALI code covers litigation only under federal statutes.

The general proposal to limit damages can be commended without endorsing the specifics of the ALI's proposed code. The scholars serving on the ALI project need time to consider code revisions in the light of *Hochfelder* and to undertake or sponsor empirical research on the effects on society of the various trade-offs in the proposed code. The value of those trade-offs cannot be determined without such research.

Liability Limitation by Contract or Disclaimer

Limiting professional responsibility by contract and disclaimer has been suggested by Gordon Samuels and R. H. Duncan, writing in an Australian and a New Zealand journal, respectively. Samuels proposed that auditors include language similar to the following in contracts with clients:

> X and associates shall not be liable to A Company Limited in damages or otherwise for any negligence or breach of contract or duty whatever and howsoever caused or arising by them, their servants or agents in or arising out of or in any way connected with the performance of this contract. [1971, p. 12]

Samuels also suggested that auditors give the following disclaimer to users of financial statements, advice, or information:

> This advice (or as the case may be) is furnished for the information and the use of the X Company only. We do not undertake to the X Company or any other party any responsibility for its accuracy. We expressly disclaim to the X Company or any other party any responsibility for any misstatement, error, inaccuracy, or omission which may appear in it whether as a result of negligence on the part of ourselves or our employees or agents or any other person or otherwise howsoever. [1971, p. 12]

Would that the solution were as simple as that! Even if it were, it is questionable that this kind of solution would be in the public interest. Samuels himself noted several problems with the contractual exclusion:

> Whether any firm of accountants would be prepared to employ a clause of this sort is of course another matter, but in law they could. There are limitations upon the effect of this as an exclusion clause. First, no such stipulation will be effective to exclude liability for a substantial failure to perform the contract at all. Secondly, it will not normally serve to protect the accountant's employees from the consequences of their own negligence, because they are not parties to the contract. [1971, p. 12]

Moreover, the auditor's legal problems do *not* arise primarily from the auditor-client relationship. The contractual disclaimer seems to suggest a sledgehammer as the appropriate instrument with which to kill a mosquito.

It is difficult to believe that a disclaimer of responsibility to third parties would be acceptable in the United States. Third parties are not bound by disclaimers under existing case law. Such a disclaimer denies to users of financial information the very assurances that the auditor is retained to provide. Surely it would be unacceptable to the stock exchanges, the SEC, and the public.

Limitation of Damages Through Governmental Insurance

Fiflis suggested that "one way to spread the loss adequately among all those who participate in investment activity would be to legislate establishment of a single governmental insurance fund, such as the Federal Deposit Insurance Corporation, with premiums paid on share transactions" (1975a, p. 107).

Proposals of this type, while superficially attractive, have major drawbacks. First, an audit environment in which litigation would be greatly reduced would prevent the good that does arise from the ever-present threat of litigation. Second, it is not clear whether such insurance is intended to protect investors against business and market risk as well as against information risk. If it is, this would mean a major change in the function and structure of securities markets and possibly of the entire economic system. If only protection against information risk is provided, an insurance scheme would be less drastic. However, it is difficult to visualize the "average prudent investor" as being able to draw the distinction between information, business, and market risk. A "no fault" concept of insurance is appropriate only when a business or market risk does not exist. Moreover, since information risk is currently insured against, in a sense, by underwriters, attorneys, and auditors, the cost of that "insurance" is already partially socialized through the fee structure.

Changes in the Legal Process

Referring Accounting Issues to a Master

Civil and criminal actions against auditors generally involve complicated points of accounting, auditing, and law. A judge and, if the action is resolved through a jury trial, the jurors as well, will often be expected to understand accounting principles and auditing standards and their application in specific circumstances. Subtle points of law must be explained in the judge's charge to the jury. Some auditors and lawyers have suggested that the burden this places on the judge and jury system is unreasonable. They have proposed alternatives, such as the use of court-appointed "masters" in complicated cases.[10]

Reiling and Taussig discussed the use of special masters in cases involving accounting questions:

> One implication of the phenomenon whereby judges and juries are shaping accounting practice is that defendants may wish to give new consideration to the advisability of urging the Court to refer accounting questions to a special master. It seems reasonable that a master learned in accounting would handle accounting questions more capably than a lay judge or jury.
>
> The Federal Rules of Civil Procedure permit the District Courts to appoint a special master and to refer matters to him. The judge has considerable discretion over the scope of the reference. For example, the master may be directed to report only on a particular issue, or he may be directed to receive and report on evidence only.
>
> Judicial discretion over the use of a master as opposed to the scope of the reference is more limited. In a jury trial a judge is authorized to refer questions to a master only when they are complicated. In a trial without a jury the master may be used only when some exceptional condition requires it. Thus, although a master cannot be used at the whim of the litigants or of the court, the option generally is available since many cases involving accounting issues would qualify as "complicated" or represent "exceptional circumstances."
>
> Reference of accounting issues to a master both solves and creates problems. Difficult questions receive the sophisticated consideration they deserve; but selection of the master becomes a point of contention among plaintiffs, defendants, and judge. In addition, reference to a master generally delays the case and adds to its cost. On balance, the procedure would seem to have particular merit in cases where the accounting questions are either particularly numerous and/or difficult.[11] [1970, pp. 44]

Masters might be particularly appropriate when the evidence is clearly too complex for a jury to understand, and the judge concludes that he, too, does not have the necessary background and experience. For example, one court denied demands for a jury trial in an antifraud case because the accounting issues were held to be too complex for jury determination (*In Re Boise Cascade Securities Litigation* (1976)).

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10. See, for example, Solomon, Chazen, and Augenbraun, 1976. They also note that "in civil litigation involving the federal securities laws and questions of financial statement presentation and disclosure, both plaintiff and defendant almost always waive their right to a jury trial and permit the case to be heard by a judge" (p. 71).

11. Reiling and Taussig also cited the actual use of a special master in "*601 West 26 Corp.* v. *Solitron Devices Inc.* . . . There the special master supervised the taking of 401 pages of minutes which produced findings on 14 accounting questions. The questions ranged from whether the accountants had subordinated their judgment to that of the client to the determination of whether earnings were artificially inflated or otherwise misrepresented. The District Court disposed of the case—vindicating the accountants—based on the findings and conclusions of law of the special master" (1970, p. 53).

The court stated "the factual issues, the complexity of the evidence that will be required to explore those issues, and the time required to do so leads to the conclusion that a jury would not be a rational and capable fact finder." The judge noted his "experience in presiding over other complicated cases involving commercial matters." In other circumstances, a judge might determine that he did not have the necessary background and experience and might then turn to the use of a master in a fact-finding capacity. In another case involving antitrust litigation, the extremely complex assessment of damages was referred to a special master who conducted hearings and reported his findings to the court (*Trans World Airlines* v. *Hughes* (1969)).

There is, however, no clear evidence that judges or juries generally lack the ability to understand accounting and auditing issues or that justice or the public interest has been thwarted by a lack of understanding. Specific cases can be cited in which defendants, their attorneys, or the American Institute of Certified Public Accountants have asserted that misunderstanding, particularly of the judgmental nature of auditing decisions, led to inappropriate outcomes. However, the question of whether a court did in fact understand some subtle point of accounting or auditing is often clouded by whether they should be expected to understand it. For example, in its amicus curiae brief to the U.S. Court of Appeals in the *National Student Marketing* (1975) case, the AICPA argued that

> the trial court committed prejudicial error in its instructions to the jury by failing to instruct it as to the distinct difference between the responsibility of an independent accountant with respect to financial statements he has audited and reported on and his very limited responsibility with respect to financial statements which he has not audited and on which he has not reported.

Whether the public, as represented by the court, should be expected to recognize this particular "distinct difference" is arguable, since auditors are associated with both audited and unaudited statements, and procedures often are applied to unaudited statements that resemble those applied to audited statements. Judges and juries do have varying degrees of knowledge, and masters might insure the court's awareness of the underlying issues in complicated cases. However, there is no assurance that their use would lead to different results.

Two other related proposals appear less promising than referring accounting and auditing issues to masters.[12] One is the use of arbitration panels, similar to those used to settle medical malpractice claims

12. For an elaboration of these alternatives, see Solomon, Chazen, and Augenbraun, 1976, p. 74.

in some jurisdictions. However, the arbitration model would have to be substantially modified to accommodate third-party claims against auditors. Also, an arbitration system might encourage additional claims because the process is easy and inexpensive, although the amounts of the awards might be lower.

Another alternative would be the use of referee panels of experts under the aegis of the AICPA to provide courts with technical assistance, similar to the filing of an amicus curiae brief. Given what some have viewed as an extreme reluctance of auditors to testify against their brethren, AICPA association with a referee panel might be sufficient to make it immediately suspect to the plaintiff. On the whole, if expert advice on technical matters is needed, a master operating as an agent of the court would give at least the appearance of an independent, unbiased point of view, and that is surely the minimum that would be required to make this proposal palatable to the public.

Adherence to GAAP and GAAS as an Absolute Defense

In ascertaining if an auditor has in fact exercised the required level of care, the courts look to several standards against which the conduct can be compared.[13] Those include:

1. The standards of the auditor's own firm.
2. Customs and practices of the profession.
3. Formal professional standards.
4. Expert testimony.
5. Textbooks and journals.
6. The legal standard of conduct to be established by the court in a particular case.

Items 2, 3, 4, and 5 serve as sources of generally accepted accounting principles and generally accepted auditing standards. The firm's own standards (item 1) may point out an individual's performance failure. Item 6 indicates that the courts have not always limited themselves to items 1 through 5 in determining the appropriate standard of care.

The issue here is the extent to which conformity to formal professional standards should be an effective defense for auditors. Generally, it is; the courts have only on rare occasions rejected adherence to generally accepted accounting principles and auditing standards established by authoritative bodies as an effective defense. "The courts

13. Much of the following material is from Fiflis, 1975a, pp. 65-87.

have generally encouraged the auditor to adhere to these professional standards by shielding him from liability when he does" (Earle, 1975, p. 147). The district court in *Herzfeld* disregarded authoritative auditing standards, but the appellate decision constituted a strong declaration that liability was founded on the defendants' knowing departure from recognized professional standards.

However, when specific standards have not been established by formal pronouncements or when courts have deemed the standards incomplete, compliance with authoritative pronouncements is not sufficient to excuse an auditor from liability. For example, *U.S.* v. *Simon* (1969) demonstrated that conformity to a formal set of authoritative accounting principles was insufficient if that set did not specify the appropriate accounting for the item at issue. In *Adams* v. *Standard Knitting Mills* (1976), the court held that the auditor "failed to follow and apply general accounting principles which was essential for fair presentation . . . by not disclosing or compelling . . . management to disclose its gross edp deficiencies," even though such disclosure was not then required by authoritative prouncements. Fiflis contended that "communication of financial data to lay readers, based on accounting principles and reporting requirements, should be tested by the standard of meaningfulness to the layman, while those processes of auditing, consisting of data collection, testing and drawing of inferences, are a matter for the expertise of an auditor, to be regulated by those who know something about the processes" (1975a, p. 81).

Accountants have sought the same type of treatment that physicians receive in the courts.

> In the area of medical malpractice the more general view is that: (a) the standard of conduct to which the courts will hold a defendant is the custom of the profession or, even in the absence of a custom, the view of experts; the jury usually is not authorized to question the wisdom of the custom or expert judgment as being itself unreasonable; and (b) the plaintiff cannot prevail unless he produces expert testimony of nonconformity by the defendant with custom or expert judgment.
>
> The effect of the dual requirements that the plaintiff show nonconformity with custom or expert judgment and that he do so with medical experts provides a very real insulation for medical practitioners from the vicissitudes of litigation. The costs in terms of injustice in the cases of nonrecovery is considered to be appropriate when weighed against such benefits as the availability of medical practitioners and the willingness to serve—benefits that some fear might be lost if a different standard of conduct were imposed.[14] [Fiflis, 1975a, p. 66]

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14. Fiflis pointed out, however, that "in one area of medical malpractice, termed '*informed consent*,' which deals with the question of whether a patient who consents to a particular treatment has been adequately informed of risks, a few courts hold that the adequacy of the practitioner's communication of the risks is not to be tested by practitioners' customary disclosures but is a question for the lay jury. Hence, expert testimony of judgment or custom is not indispensable to the plaintiff's case. Nor is the defendant's expert evidence of custom invulnerable to a jury determination of unreasonableness" (1975a, pp. 66-67).

Why should not the legal process provide auditors with the same insulation from the "vicissitudes of litigation"? Fiflis suggested reasons for the unique treatment given doctors and argued that those reasons are not relevant to auditors.

> The bases for the view that professional standards should be conclusive in the medical malpractice cases have been (1) practicality (viz. it is said that judges and juries are usually not competent to determine whether a doctor acted reasonably, and hence no other rule is workable) and (2) a policy to preserve the profession from second guessing by jurors, which might result in inhibiting doctors from exercising their best judgment. A third justification might be based on an application of economic principles leading to the conclusion that custom always perfectly balances the costs and benefits.
>
> Whatever the persuasiveness of these reasons for making custom conclusive in the medical malpractice cases, a question we need not consider, it does not seem overpowering when the questions involve the reasonableness of accounting principles or the conduct of an audit. First, as to practicality, auditing and accounting seem no more complex than certain other highly technical occupations when the questions are narrowed down by the judge and the lawyers. For example, a case likely to arise some day will involve the reasonableness of auditing a computerized set of records when none of the auditors on the scene knows anything about computers. The question can be made to appear complex but it would seem that in some cases, at least, it would not be different from a question of whether a reasonable safety precaution for a steel mill is to require high friction stair treads in work areas. As to the second basis, encouraging the best judgment of auditors, one would intuit that fear of liability would sharpen judgment. In any case, these two bases for fixing custom as the standard require behavioral study for verification of the asserted practicality and enhanced room for professional judgment. The third basis, the assertion purportedly based on an economic analysis, suffers from the fact that some of its supporters are afflicted with the Pygmalion Syndrome—they must not forget that their economic model is not the real world and therefore can be nothing more than a basis for establishing hypotheses for experimentation. Thus it too requires empirical verification. But logic can supply us with help, and we do not need experience in this particular case. Even if the model were realistic, to say that custom will rise to a point at which the costs of the customary care will be balanced by the benefits in a doctor-patient or businessman-customer situation is one thing; to say this in the auditor-public investor situtation is another. One of the proponents of economic analysis points out that in the doctor-patient situation the patient will pay extra for treatment until the last dollar spent buys just one dollar of accident cost reduction. "However, no firm [for example, of auditors] will have an incentive to take precautions against accidents that are dangerous only to people [for example, public investors] with whom the firm does not, and due to high transaction costs cannot, deal."[15] [Fiflis, 1975a, pp. 84-86]

Some of Fiflis's views are at least arguable. He suggested that accounting and auditing issues are less complex than medical issues,

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15. For an opposing point of view, that the courts should treat doctors and accountants similarly in evaluating their performance, see Solomon, Chazen, and Augenbraun, 1976, p. 72.

and therefore more amenable to jury evaluation. However, some auditors have suggested that this may be the result of efforts by the medical profession to create a mysticism about their specialized learning, as contrasted with the accounting profession's traditional desire to communicate both the nature of its opinions and all of the supporting reasons.

To some extent, fear of liability may sharpen judgment. However, it may also lead to a retrenchment from responsibility as the profession's rational response to the escalation of such risks. Even if the fear of litigation does lead to greater care, it is not uniquely applicable to the accounting profession. Moreover, if potential liability is to serve as a stimulus to effective performance, the profession must have some confidence that effective performance can be measured in advance of litigation. Without the structure of generally accepted accounting principles and auditing standards to rely on, fear is more likely to produce the undesirable effect of attempting to meet the minimum standards of a judge or jury rather than efforts to comply with established professional rules.

However, the unique treatment of doctors may be inapplicable to auditors for another reason. Litigation against auditors, unlike that against doctors, proceeds not just under common law, but under federal statutes that set forth responsibilities and remedies to achieve specific objectives. Communication to third parties is an important aspect of those responsibilities. It may be inappropriate to ask a juror to determine the adequacy or correctness of a particular medical procedure in a particular circumstance; it is more appropriate, however, to ask a juror if an auditor's communication is understandable to investors. Lay jurors are generally not doctors, but they are often the public for whom the auditor's communication is intended. Perhaps if doctors were required to provide detailed memoranda explaining each of the judgments and steps they had taken in a professional capacity, there might be less distinction between the treatment of the two professions in the courts.

Extension of the "Safe Harbor" Concept

Two possible adverse consequences to society of the litigious environment in which auditors work and the fear of creating new bases for litigation were noted in chapter 6. One was an apparent reluctance by both individual auditors and the profession as a whole to become associated with new types of information such as forecasts and current values. The other was that the costs associated with audits of high-risk clients might become prohibitive in relation to the social benefits to be achieved. The granting of an appropriate "safe harbor" by either legislation or SEC action, similar to that adopted by the SEC relating to replacement cost disclosures, could remove at least one significant impediment to professional involvement with new forms of information and high-risk clients. A safe harbor rule provides protection by placing a burden of proof on the person seeking to establish liability that a certain, specified standard was not met.[16]

Safe harbor rules might be made available only when auditors are asked to assume new responsibilities or significantly extend old ones. The safe harbor device would be appropriate only when the proposed extension represents a sharp increase in the level of responsibility or new, untried, high-risk areas. After an appropriate period of experience with the new type of information, the continued need for the safe harbor should be reconsidered. Society would be better served if auditors were more often involved with new types of information. Such involvement would serve to improve the quality of such information and hasten the development of improved standards. The involvement would be more likely to occur if standards for proper auditor conduct could be agreed on in advance that would serve as a means of limiting liability if the auditor has performed in accordance with those standards.

With regard to marginal enterprises, Mautz argued that

> the best interests of the public accounting firm would be to steer clear of any client that might possibly pose financial difficulties. One can also argue that the best interests of the economy require that every promoter be given a chance because we never know when a speculative undertaking may prove to have significant social benefits. Perhaps what we need is something a little like the public defenders role played by lawyers. Perhaps some auditors should be designated or assigned to serve clients who otherwise would not be able to obtain the services of a reputable firm. In such cases, the "assigned" auditor might require some special protection against litigation. [1972, p. 92]

Assessment of Costs Against Unsuccessful Plaintiffs

Several sections of the federal securities acts permit the courts to assess costs (including defense costs) against plaintiffs and to require plaintiffs to post a bond for those costs. An extension of this power, such as that proposed in section 1418(d) of the American Law Institute's Federal Securities Code, to all sections of the securities acts that permit private litigation for monetary damages would serve to discourage "nuisance" or "strike" suits against auditors. The ability of the court to assess costs against unsuccessful plaintiffs would not restrict plaintiffs' access to the judicial process. The court would be empowered, but not required, to assess costs, and that power could

16. See, for example, the language of the safe harbor rule in SEC Accounting Series Release no. 203 (December 9, 1976), *Notice of Adoption of Amendment to Rule 3-17 of Regulation S-X, Relating to Disclosure of Certain Replacement Cost Data.*

be used with discretion by the court when, by objective standards, the complaint was frivolous or had little chance of success at trial. Particularly if the code adopts a negligence standard for private actions for damages, the ALI provision would be consistent with the view that express civil remedies allowing recovery for negligent conduct should be subject to procedural restrictions.

Revised Standards for Class Action Suits and Elimination of the Contingent Fee System

The combination of class action suits and the contingent fee system has undoubtedly increased the exposure of auditors to litigation. Some of the litigation has been meritorious and some has not.

For auditors to advocate elimination of or restrictions on class action suits and the contingent fee system might appear to be merely self-serving. This is not to suggest that refinements of the system are not possible, but the refinements can be achieved by judicial as well as by legislative or regulatory action. As noted earlier, courts now have the power to prevent abuses of class actions, and they have lately begun to exercise that power. The courts also approve the portion of an award or settlement that is allowed for attorney fees. Whether society has been ill-served by aspects of the litigation process over which the courts themselves have the power to exercise control is arguable, particularly when there has been a recent trend, evidenced in part by the *Hochfelder* decision, to limit access by private litigants to the federal courts in securities cases.[17]

Moreover, the profession's image is not enhanced by proposals that may even appear to be self-serving. For example, in May 1975, the professional ethics division of the AICPA issued a proposed ruling that would have made it unethical for a member to serve as an expert witness or consult in connection with litigation for a contingent fee. The proposed ruling, regardless of its intent, met with substantial opposition from the plaintiff's bar and was withdrawn. The publicity, generally unfavorable, that greeted the proposal could not be withdrawn.

Institutional Changes to Improve Auditor Performance

In addition to the proposals for changes previously discussed, there have also been numerous suggestions for fundamental institutional changes that would improve auditor performance and thereby lessen exposure to litigation.

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17. *SEC General Counsel's April 26, 1976 Memorandum Regarding* Ernst & Ernst *v.* Hochfelder, Bureau of National Affairs, no. 113, June 10, 1976, p. J-3.

Publication of Case Analyses

The profession requires thorough analyses of civil, criminal, and SEC enforcement cases involving alleged audit failures if it is to understand the expectations of the courts and the SEC and react appropriately to those expectations. The analyses of cases involving alleged audit failures by the Commission on Auditors' Responsibilities was a worthwhile first step in this direction.

The AICPA, with the cooperation of accounting firms and through the use of court or SEC documents, could establish a mechanism for timely analyses of individual cases as they move through the judicial or regulatory system. The analyses should be published in a form readily available to practitioners, teachers, and others. They should consider the nature and causes of specific audit failures, the changes in auditors' responsibilities suggested by litigation and SEC administrative action, and the implications for the auditor's evolving role. The analyses would be descriptive of actual court rulings, settlements, or enforcement proceedings; they need not await the outcome of related disciplinary proceedings by professional bodies.

Increased Auditor Authority

Sterling (1972) found that "the accountant has been given a responsibility without concomitant authority." Earlier parts of this monograph have suggested ways in which the auditor has attempted to reduce his responsibility or at least abstain from accepting new ones, and Sterling suggests others. However, the courts have generally not permitted the auditor to take those courses of action.

The auditor's lack of authority stems from the power that a client's management has both to select accounting principles and to select and dismiss the auditor. One legal scholar suggested that

> virtually the only substantive limit placed on management's discretion by the accountants is that the principles management selects in preparing its financial statements must be "generally accepted." Virtually the accountant's only mechanism for enforcing this limit is his power to withhold a clean certificate from the corporation's financial statements. Yet by law, and largely by practice, the selection, tenure, and dismissal of an accountant is entirely in the hands of the management. Moreover, management is not hesitant to use this power. During the 18-month period of November 1971 to April 1973 there were approximately 400 accountant changes among the corporations which must file Form 8-K's with the SEC, and during the 18-month period of January 1973 to June 1974, there were approximately 700 such changes. At least 10 percent of these changes, and almost certainly more, were made against a background of disputes over accounting principles.
>
> The accountant's dependence on management for his tenure, when combined with management's discretion in selecting among competing accounting principles and the low standards set by the accountants for determining whether a given principle is "generally accepted," result in an

almost irresistible pressure on the accountant to go along with marginal principles. The accountant "can swallow his convictions or he can qualify his opinion, or he can resign. Usually the latter two courses are one and the same."[18]

The pressure on the accountants to go along in marginal (and even less-than-marginal) cases is considerably augmented by the fact that if an incumbent accountant does balk, a more flexible auditor can almost always be found. The result is that an accountant who uses or threatens to use his only real control over management's selection of accounting principles is likely to lose his own position without materially benefiting those who use the corporation's financial statements. Many accountants appear to regard the withholding of a clean opinion under such circumstances as a quixotic gesture. [Eisenberg, 1975, pp. 424-26]

Eisenberg's analysis suggests that the reporting requirements of Form 8-K have provided little authority to auditors in their dealings with management over the choice of accounting principles. This may result in part from the SEC's response to 8-K filings. The following exchange between Walter E. Hanson, senior partner of Peat, Marwick, Mitchell & Co., and John C. Burton, then chief accountant for the SEC, at the May 25, 1976, Wharton School conference on "The Public Accounting Profession and Its Critics" is illuminating:

HANSON: Another area I'd like to touch on, because it does reflect upon the relationship of the SEC and the accounting profession, is the disclosure on Form 8K whenever an accountant is dismissed or resigns from an engagement. When that was made part of the SEC law some three or four years ago, I thought that was a major step forward because it would pinpoint those areas where there had been major disagreements of accounting principles between the firm and the client, with the client going out to seek another accounting firm which might give them a different answer. More than a thousand of these forms have been filed, many because of mergers and so forth. There have been at least a hundred over which there were substantive disagreements between the accountant and his client. Unfortunately, I've yet to find any action on the part of the SEC related to these disclosures. What is happening, Mr. Burton, I would like to ask, with your procedures within the SEC, to look into and really punish the management that is actually going out and shopping for accounting principles? *You can criticize the accounting profession* for what they are doing and not doing, but we're human, and we are entitled to ask why you're not utilizing this very important tool that is available to you as a government regulatory agency.

BURTON: The facts are slightly, although I wouldn't say materially, different from those described by Walter Hanson. We have had to my knowledge three enforcement actions growing out of 8K. We have had at least a dozen cases where we have written letters asking questions about this. There is a staff accountant in my office who regularly reviews all 8Ks

18. Eisenberg attributes the quote to Leonard Spacek.

> reporting auditor changes and he calls to my attention any items which he considers to be significant, worthy of additional follow-up, and then I review those. In many cases, we think the purpose of the rule has been served by disclosure. Everyone doesn't warrant an article in the *Wall Street Journal*. But there are times when Fred Andrews or someone else picks up one and asks about it, so fundamentally the disclosure objective is being met. It is conceivable that we should pursue more vigorously some of the specific cases of disagreements. Sometimes the departing auditor does not know that we have followed up because our follow-up goes to the company and to the successor auditor. On a couple of occasions I have taken it upon myself to write the successor auditor calling his attention to the 8K and related SEC policy and normally in those cases the result is improved disclosure even though perhaps it could be said that in part it comes out of the pockets of the accountant who departed. But in most cases, the result of such a change is that the successor auditor does not generally approve the accounting that the predecessor auditor refused to accept.

Sterling saw "only one other course of action open to us—since we cannot lessen the responsibility and since the responsibility outweighs the authority, we must increase the accountant's authority" (1972, p. 37). This would be accomplished by denying to managements "the power to hire and fire accountants and the power to select from diverse accounting principles as they see fit" (Sterling, 1972, p. 40).

Eisenberg argued that both of Sterling's proposed changes are required:

> Vesting in the accountants responsibility for the selection of accounting principles is a necessary condition to ensure the integrity of financial statements, but not a sufficient one. As long as selection among competing accounting principles is discretionary, the purpose of such a shift could be subverted too easily if management itself retained the power to select and dismiss the accountants. As a second structural reform, it is therefore necessary to shift that power too out of management's hands. One proposal to accomplish this objective is embodied in the thorough and persuasive argument of Douglas Hawes that the power to appoint and dismiss a corporation's accountant should reside in the body of shareholders rather than the board. Left to itself, however, that body would undoubtedly look to the board for guidance on selection and dismissal, could neither determine the scope of the audit nor the compensation of the accountant, and could not give the accountant periodic direction and support. A complementary step is therefore necessary: Every publicly held corporation should be required to have an audit committee, comprised entirely of independent directors, which would have the exclusive power (1) to nominate and recommend dismissal of the corporation's accountant on behalf of the board, and (2) to direct the accountant's activities and set the terms of his engagement. [1975, pp. 432-33]

The two proposals can be considered individually. Placing the authority to dismiss an auditor with an independent audit committee would significantly increase the auditor's authority. In fact, such a structural reform might remove the necessity for shifting the responsibility for the selection of accounting principles to the auditor. Retention by management of the responsibility to select accounting principles is desirable, particularly if other means exist to increase the auditor's authority. At the very least, the selection of accounting principles cannot be completely divorced from the data recording function, and no persuasive case has ever been made that the auditor's role should encompass the recording function. In fact, Mautz and Sharaf (1961) have suggested that performing such a role would reduce the auditor's independence.

Strengthening Controls and Discipline Over Auditors

The accounting profession has taken significant steps in recent years to strengthen controls over the quality of practice. Still stronger controls and improved disciplinary procedures would both increase the level of performance and strengthen the profession's case in seeking public support for changes in the legal and judicial process. Among the steps that could be taken are better education in preparation for entry into the profession, mandatory continuing education, mandatory peer review, and a stronger professional disciplinary process. Increased levels of auditor performance are not costless, however, and benefit-cost models do not exist to determine the optimal level.

8

Acceptable and Unacceptable Proposals for Change

As the discussion in chapter 7 indicates, numerous proposals have been advanced for changing the legal environment. Some involve only minor tinkering with the legal and judicial process, while others involve major revisions. Some of these views are undoubtedly caused by frustration derived from the genuine belief that the legal system has worked to the detriment of the public accounting profession. Other proposals suggest changes that would benefit both society and the public accounting profession.

Criteria for Evaluating Proposals

In analyzing the impact of the legal environment on professional practice, both the desirable and undesirable consequences to society were considered. It is impossible to measure the societal benefits and costs of the present process for adjudicating charges against independent auditors. However, it is possible to evaluate how to obtain or enhance some of the desirable consequences (benefits to society) by means other than litigation without generating other undesirable consequences (costs to society). Similarly, it is possible to evaluate how to alleviate some of the undesirable consequences through changes in the legal and judicial process without at the same time reducing the desirable consequences of the present environment. The result would thus be a net increase in the economy and effectiveness with which individual auditors and firms carry out their assigned role in society.

The profession should not support proposals for changes that seek merely to benefit individual auditors or firms. For a proposed change to be both credible and acceptable, it should enhance the ability of the profession to fulfill its assigned role more economically and effectively. Proposed changes supported by the profession should not seek to relieve the auditor of liability for substandard performance. The goal should be to enhance the net benefits of the audit function to society.

Acceptable proposals should not seek changes in the overall judicial system. They should be limited to those aspects of the process of adjudicating disputes that have a unique effect on auditors. For example, responsibility for specifying auditing standards, including the determination of due care in specific situations, is presently shared by the accounting profession, legislatures, the SEC, and the courts. A specific error or omission by the auditor, such as poorly supervising an assistant, could be mere negligence, reckless conduct, or willful intent to deceive. How and by whom should the degree of culpability be determined in a specific case? The SEC could set highly specific criteria for determining the degree of culpability. The criteria would be known in advance and would provide guidance useful in audit planning, but they would be inflexible. Alternatively, the criteria could be determined by the courts on a case-by-case basis. This would achieve the desired flexibility, but the criteria would, in effect, be applied retroactively and would not be known in advance.

This philosophical issue has existed for many years; it is not limited to accounting and auditing, but affects many professions. Legal scholars and others have long debated whether case-by-case court development of specific standards of conduct is preferable to legislation or administrative rules.[1] This is not an issue to which the accounting profession can contribute some unique expertise.

The combination of class action suits and the contingent fee system operates to increase the exposure of auditors to both meritorious and nuisance suits. But those aspects of the legal climate have the same effect on all professionals. They are also, at least at present, an integral part of the legal system. Moreover, the courts are empowered with the means of preventing abuses of the class action procedure. An attempt by the profession to change these aspects of the system would probably be viewed as self-serving and unattainable. It would probably reflect a misunderstanding of the balance presently achieved and achievable by legislation and the courts.

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1. See, for example, the discussion in Davis, 1969.

On the other hand, other proposals for changes that the profession could endorse would not face those criticisms. Such changes would enhance the efficiency and effectiveness of the audit function. Other segments of society could accept and implement them. They would reflect a degree of expertise and area of interest that knowledgeable auditors would reasonably be expected to possess.

Proposals That the Profession Should Support

Proposals that meet the suggested criteria and that should receive the profession's support include—

1. Statutorily limit damages, as would the ALI's proposed Federal Securities Code. Some form of statutory limitation is necessary for the continued healthy existence of a public accounting profession in the private sector. Increasing insurance costs, and even the possibility that significant insurance coverage may not be available in the future, may place an intolerable burden on the profession. The ALI proposal considers the statutory limitation as part of a trade-off for a negligence standard in what are now 1934 act filings. However, both the precise formulation of the limitation to damages and the necessity or appropriateness of any trade-offs cannot be determined at this time. Further research is needed to determine the precise formulation of the damage limitation and the appropriate standard of care that would best serve both society and the profession.

2. Increase the ability of the courts to assess costs against unsuccessful plaintiffs. The provision in the ALI Federal Securities Code that allows the court to assess costs, including attorney's fees, against any party and to require an undertaking for the payment of such costs in private actions would extend the existing provisions for assessment of costs and posting of a bond under some sections of the securities acts to all sections of the acts and thereby discourage nuisance suits.

3. Increase the use of "masters" appointed by the court in cases involving complex accounting principles or auditing standards. Auditors believe, rightly or wrongly, that judgments against them are frequently the result of lay juries or judges making decisions on fine points of accounting and auditing without adequate impartial advice.

4. Extend the safe harbor concept. Regulatory agencies and legislatures should grant safe harbors when auditors are called on to assume new responsibilities or significantly extend old ones. Auditors have been justifiably reluctant to take on new responsibilities in

the present litigious environment. Society would be better served by auditor involvement with types of information beyond the historical, annual financial statements even without the attendant liability that would otherwise attach to that involvement.

5. Analyze and report audit failures. Through an analysis of cases involving auditors as they move through the judicial or regulatory system, individuals and firms would be able to keep abreast of current practice developments at relatively little cost. Educators and textbook writers would also have a valuable source of information. Knowledge of the nature and causes of specific audit failures would have a beneficial effect of discouraging the repetition of substandard practices.

6. Decrease the authority of management to hire and fire auditors. An increase in the auditor's responsibility to enterprise audit committees composed of outside directors would reduce the auditor's responsibility to management and increase his authority in exercising his judgment in accounting and auditing matters.

Proposals That the Profession Should Not Support

Proposals that do not meet the suggested criteria and should not receive the profession's endorsement include—

1. Limit liability by contract or disclaimer. A limitation by contract would presumably apply only to those in a contractual relationship with the auditor, and expanded liability to clients has not been a major factor in the overall litigious environment in which auditors work. A limitation of liability by public disclaimer would be no more effective than a plea for civil or criminal immunity. It would also serve to negate the auditor's role of providing assurance on the credibility of financial information.

2. Provide insurance for investors against losses caused by auditors' substandard performance, such as through an FDIC type of arrangement. An insurance scheme to protect investors against business or market risks would entail a major change in the function and structure of securities markets and, possibly, of the entire economic system. An insurance scheme to protect against information risk would be less drastic, but users would likely not understand the distinction between information risk, which could be insured against, and business and market risks, which could not.

3. Advocate that legislatures and courts consider adherence to authoritative auditing standards and accounting principles to be an adequate defense in civil and criminal cases. The courts have not

often rejected generally accepted accounting principles and auditing standards as effective defenses. When the issue has been addressed, it is usually in reference to reporting or disclosure rules. Thus, the problem is not severe. Moreover, for the profession to suggest that it alone has the right to determine its role and responsibilities would appear to be self-serving.

4. Impose tighter standards for class action suits or eliminate contingent fees or both. The profession's advocacy of these proposals would probably be viewed as self-serving. Class actions and contingent fees are not unique to cases involving auditors. The courts are already empowered to take steps to prevent abuses in these areas and have lately begun to exercise that power.

5. Give auditors, rather than management, the authority to select accounting principles. Increased auditor responsibility to audit committees would probably avoid the need for specific authority to select accounting principles. Moreover, the selection of principles cannot be completely divorced from the data recording function, and no persuasive case has yet been made that the auditor's role does or should encompass the recording function.

The profession must recognize that it cannot expect statutory or judicial relief from litigation unless it takes appropriate measures to put its own house in order and unless it is willing to accept added responsibilities in exchange. The recommendations in this paper, taken together, are designed to achieve that relief in a context of both new responsibilities and a higher level of performance for existing responsibilities.

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