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CAPPING AUDITOR LIABILITY: UNSUITABLE FISCAL POLICY IN OUR CURRENT FINANCIAL CRISIS

INTRODUCTION

Solving the current global financial crisis will require increased investment in the capital markets coupled with appropriate government intervention.¹ In order to ensure that investors will provide the impetus necessary to revive our economy, it is of the utmost importance that investors are confident in our domestic capital markets.² As one commentator has noted “[i]t may be the [confident] investor who has [created] a multi-trillion dollar public securities market in which corporations . . . annually raise hundreds of billions of dollars of new capital But there is good reason to suspect that trusting investors may be the heart and soul of the modern market.”³

In the first quarter of 2009, the household sector, consisting of individual investors, held over 36.9% of corporate equities in the United States.⁴ From 2007 through the third quarter of 2009, investment in corporate equities by the household sector alone, dropped from a high of 917 trillion dollars to a four year low of 518 trillion dollars.⁵ This drastic drop in individual investment correlates to severe decreases in investor confidence.⁶ Individual investors play an irrefutable role in the economy, and they currently possess billions of dollars in liquidity that they are

1. Gregory W. Brown & Christian Lundblad, *The U.S. Economic Crisis: Root Causes and the Road to Recovery*, J. ACCOUNTANCY, Oct. 2009, available at <http://www.journalofaccountancy.com/Issues/2009/Oct/20091781.htm?action=print> (arguing that any solution to the economic crisis must begin with both, higher levels of real and financial investment, and smart national economic policies, such as capitalizing on exports and increased government spending).

2. Posting of Tom Davenport to Harvard Business Review Blogs, http://discussionleader.hbsp.com/davenport/2008/10/we_need_to_renovate_the_old_ec.html (Oct. 21, 2008, 18:56 EST); see also Ken Little, *Stock Market Often Leads Economy in Rebound*, ABOUT.COM, <http://stocks.about.com/od/investing101/a/020909stocks.htm> (arguing that in order for the stock market to lead the economy out of the financial crisis “investors must once again feel confident about the economy and the stock market”).

3. Lynn A. Stout, *The Investor Confidence Game* 35 (UCLA Sch. of Law Research Paper Series, Research Paper No. 02-18, 2002), available at <http://ssrn.com/abstract=322301>.

4. FED. RESERVE SYS., BD. OF GOVERNORS, FEDERAL RESERVE STATISTICAL RELEASE: FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES 90, tbl. L.213 (Dec. 11, 2008), available at <http://www.federalreserve.gov/releases/z1/Current/>. To compute the numbers above, the percentage of corporate equities held by the household sector was reached by dividing the dollar amount, in billions, of corporate equities held by the household sector, by the total holdings of corporate equities at market value. See *id.* It is important to note that the household sector does not include individual investors who invest through mutual funds, which accounts for another \$3304.9 billion invested in corporate equities. *Id.* at 90.

5. *Id.* at 90.

6. Dave Valiante, *Investors' Confidence in U.S. Capital Markets Drops*, WALL ST. & TECH., Aug. 15, 2008, <http://www.wallstreetandtech.com/showArticle.jhtml?articleID=210002944>.

reluctant to invest.⁷ It is this very liquidity that could revive our capital markets, thereby necessitating a policy that mends and increases investor confidence, allowing investors to reinvest in the markets as they once did.

One important way that investor confidence is developed and maintained is through the rigorous external audits that corporations undergo.⁸ Audit reports are vital in order to make investors aware of the financial health of a corporation, and bestow upon them the ability to make informed decisions on whether a particular investment is suitable.⁹ In our current financial state, the role of the auditor is paramount, and the laws that regulate the role of auditors are more crucial than ever in order to increase investor confidence.¹⁰

Like most aspects of the capital markets, statutory law heavily influences the role of auditors.¹¹ Statutory law governs much of what auditors are required to investigate and disclose to potential investors, as well as the steps they are required to take to ensure accuracy.¹² However, the threat of litigation serves as another strong force to ensure accuracy in external audits.¹³ Because the costs of potential litigation are so excessive, auditors are forced to ensure that the reports they issue to the investing public are thorough and precise.¹⁴ If the United States and major capital markets abroad were to cap the liabilities that auditors face, a major incentive to do thorough, accurate work would be lifted.¹⁵ Such a disincentive would result in a decrease in investor confidence, which in turn could have a devastating effect on the global capital markets as investors

7. See Roy Furchgott, *You've Sold Your Stock. Now What?*, N.Y. TIMES, Feb. 25, 2009, at SPG4, available at http://www.nytimes.com/2009/02/26/your-money/asset-allocation/26stash.html?_r=1&scp=2&sq=investors%20sidelines%202008&st=cse; see also Ron Lieber, *Switching to Cash May Feel Safe, but Risks Remain*, N.Y. TIMES, Oct. 8, 2008, at B1, available at <http://www.nytimes.com/2008/10/09/business/yourmoney/09money.html?scp=17&sq=investors%20sidelines%202008&st=cse>.

8. See Sarah Johnson, *The Cost of Auditor Independence*, CFO.COM, Feb. 12, 2009, <http://www.cfo.com/article.cfm/13111528>.

9. See generally Marianne Ojo, *The Role of External Auditors and International Accounting Bodies in Financial Regulation and Supervision* (Mar. 2006), available at <http://mpr.ub.uni-muenchen.de/354/>.

10. John P. Coffey, *Trouble with a Cap on Liability: Protecting Auditors Weakens Corporate Accountability*, PENSIONS & INVESTMENTS, May 12, 2008, <http://www.pionline.com/apps/pbcs.dll/article?AID=/20080512/PRINTSUB/206375828/1026/TOC>.

11. See Jeffrey W. Gunther & Robert R. Moore, *Auditing the Auditors: Oversight or Overkill?*, ECON. & FIN. POL'Y REV., 2002, at 1, 10, 14, available at http://www.dallasfed.org/research/efpr/pdfs/v01_n05_a01.pdf (discussing federal legislation of auditors).

12. *Id.* at 14.

13. See *id.* at 15.

14. *Id.*

15. CEA, *CEA Response to the EC Consultation on Auditors' Liability and Its Impact on the European Capital Markets*, Annex 1 to RC7022 (03/07) (Mar. 15, 2007), www.cea.eu/uploads/DocumentsLibrary/documents/position324.pdf.

began to invest less money.¹⁶ “Investors invest not because they trust managers, brokers, and investment advisors, but because they rely on the legal system to discourage managers, brokers, and investment advisors from behaving like the scoundrels they are.”¹⁷ Auditor liability is an integral part of the legal system these investors rely on. Despite these potentially severe side effects, there is a movement in the United States to cap the liabilities which auditors face.¹⁸ Since early 2008, there has been a concerted effort among domestic auditors to push the Treasury Department to provide public policy recommendations in favor of capping auditors’ liabilities.¹⁹

In light of the fact that there is a serious movement to cap liability,²⁰ it is necessary to investigate the devastating effects that these policies will have on the U.S. capital markets vis-à-vis investor confidence. Capping auditor liability, which will decrease investor confidence at a time when the domestic and global capital markets are so fragile and in desperate need of the economic boost that continued financial investment could provide, is an uncalled for and inappropriate policy in our current financial climate.

Part I of this note discusses the role of auditors in our capital markets and the effects that audit reports have on individual investors. Part II discusses the history of auditor regulation and legislation, the current regulatory state, and the role that crisis has played in revolutionizing the importance of the auditor in our capital markets. Part III examines the liabilities which auditors face in the current legislative and regulatory climate and the reasons why auditors are calling for liability reform. Part IV discusses the various proposals for reforming auditor liability being considered and the reasons why these various plans will be detrimental to our markets. Finally, Part V examines the potential effects of capping auditor liability in light of our incredibly fragile economic situation.

I. THE ROLE OF THE AUDITOR IN INVESTMENT & CAPITAL MARKETS

The auditor is an integral component of our financial capital markets, and it is necessary to understand the purposes the auditor serves before

16. Directorate General for Internal Market and Services, *Summary Report: Consultation on Auditor’s Liability: Summary Report*, at 14 (2007), available at http://ec.europa.eu/internal_market/auditing/docs/liability/summary_report_en.pdf [hereinafter Directorate General, *Summary Report*].

17. Stout, *supra* note 3, at 293. “The possibility that many investors invest because they ‘trust the market’ . . . offers to explain a number of otherwise-puzzling market anomalies that are difficult if not impossible to reconcile with the rational expectations model [of investors].” *Id.* at 31.

18. Tammy Whitehouse, *Audit Firms Push (Again) for Liability Caps*, COMPLIANCE WK., July 8, 2008, available at <http://www.complianceweek.com/article/4243/audit-firms-push-again-for-liability-caps>.

19. *Id.*

20. *Id.*

investigating why the liability reforms called for would be so detrimental.²¹ For over half a century, the Securities and Exchange Commission (SEC) has supported increased auditor responsibility and “gatekeeper” activity, as a means of ensuring the stability of the financial markets and increasing investor confidence, thereby providing for further investment in the capital markets.²² The external audit report is an integral tool in the capital markets, as it signals to investors that the information which management releases in regards to the financial health of a corporation is reliable.²³ The auditor serves as an independent party that can verify the validity of the corporation’s statements and bolster investors’ confidence when selecting where to invest their money.²⁴

The SEC believes that the key to promoting investor confidence lies in auditor reports that are high quality, thorough, and inform the potential investor of the risks involved in purchasing particular securities.²⁵ The external audit is the preferred mode of oversight because it purports to be more thorough and accurate than the internal audit reports that the corporation creates.²⁶ If auditors do their job properly, fraud, misstatements, and omissions should be avoided, and investors can be confident in relying on financial statements as a guide to proper investment choices.²⁷

Audit reports have very real and significant consequences on whether investors are willing to purchase or retain shares of a corporation.²⁸ Statements by the auditor that even appear to question the fate of a corporation are enough to make current shareholders sell their interests and impede future investment in the corporation.²⁹

The continued reliability of the external audit report is crucial to improving investor confidence in our capital markets, which is increasingly

21. See generally Gunther & Moore, *supra* note 11.

22. SEC, The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, <http://www.sec.gov/about/whatwedo.shtml> (last visited Apr. 12, 2010).

23. See generally Ojo, *supra* note 9.

24. *Id.* at 2.

25. See U.S. GEN. ACCOUNTING OFFICE, SECURITIES MARKETS: OPPORTUNITIES EXIST TO ENHANCE INVESTOR CONFIDENCE AND IMPROVE LISTING PROGRAM OVERSIGHT 102 (2004).

26. Johnson, *supra* note 8. The external audit is seen as a necessary line of defense because internal auditors are employed by the company and there are potential conflicts of interest inherent in this position. *Id.* Often internal auditors report to the Chief Financial Officer (CFO), and it is within the CFO’s department that financial misstatements can occur. *Id.* It might be in the best interest of the internal auditor not to report certain misstatements, if it would ensure further job security. *Id.*

27. James H. Irving et al., An Empirical Examination of the Impact of Liability Caps on the Auditing Market 8 (Feb. 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1490056>.

28. James Dornbrook, *Highlighting Risk: Audit Reports that Question a Company’s Ability to Continue as a Going Concern Can Light a Fire Under Investors*, KAN. CITY BUS. J., May 16, 2008, available at <http://kansascity.bizjournals.com/kansascity/stories/2008/05/19/focus19.html>.

29. *Id.*

important as of late.³⁰ With the recent financial crisis in the American market, it has become necessary to find new sources of capital to pump back into our failing system.³¹ “It’s really about how confidence evolves Yes, fundamentals are bad, but if investors don’t have confidence to lend money to the real economy, then the real economy won’t be able to progress.”³² One of the best ways to promote this investor confidence and encourage investors to put much needed funds back into our capital markets is to ensure that the information they are receiving is valid and informed.³³ The Center for Audit Quality recommends that “[t]o improve their confidence in the U.S. capital markets . . . investors support the creation of an institute to enable auditing firms to share experiences and develop best practices for fraud prevention and detection.”³⁴ There is also a push for rules that require further public disclosure, as well as forms that are easier for the average investor to read and comprehend, in order to allow more informed investment decisions.³⁵ All of these efforts would further the goal of increasing transparency of corporate financials and promote further investment and involvement in the capital markets.³⁶

As the economy is now in a recession, the necessary revival of the capital markets will be facilitated by increased investor confidence as a means of ensuring continued financial investment.³⁷ Investor confidence has clearly been affected by the current financial crisis.³⁸ “[F]or investors, the level of pessimism and fear is so obvious it hardly needs to be measured, but it is confirmed by the data.”³⁹ In the midst of the most recent financial crisis, a poll “of its members by the American Association of Individual Investors [showed] bearishness ha[d] risen to 56.7% bearish, and bullishness had dropped to only 21.7%”⁴⁰ The same poll, a week later showed “55.1% [of members] were bearish, [and] only 24.3% [were] bullish.”⁴¹ In addition, “the Fear Index [VIX Index] . . . show[ed] a

30. Mary Schapiro, Chairman, SEC, Speech at the SIFMA Annual Conference: The Road to Investor Confidence (Oct. 27, 2009), available at <http://www.sec.gov/news/speech/2009/spch102709mls.htm>.

31. Valiante, *supra* note 6.

32. Jeremy Gaunt, *Markets’ Success in September Depends on Investors’ Confidence*, INT’L HERALD TR., Aug. 31, 2008, available at <http://www.iht.com/bin/printfriendly.php?id=15762397>.

33. See generally Valiante, *supra* note 6.

34. *Id.*

35. *Id.*

36. See generally *id.*

37. Schapiro, *supra* note 30.

38. Valiante, *supra* note 6.

39. Sy Harding, *Consumer and Investor Sentiment!*, FIN. SENSE, Feb. 27, 2009, <http://www.financialsense.com/fsu/editorials/harding/2009/0227.html>.

40. *Id.*

41. *Id.*

considerably higher level of investor fear than at the bottom of any of the legs down in the 2000–2002 bear market.”⁴²

State Street Global Markets, an investment-trading branch of a publicly traded corporation, also creates an Investor Confidence Index to measure investor confidence in the capital markets.⁴³

The State Street Investor Confidence Index measures investor confidence on a quantitative basis by analyzing the actual buying and selling patterns of institutional investors. The index is based on a financial theory that assigns precise meaning to changes in investor risk appetite, or the willingness of investors to allocate their portfolios to equities. The more of their portfolio that institutional investors are willing to devote to equities, the greater their risk appetite or confidence [in the capital markets].⁴⁴

In 2007, investor confidence of North American investors in the capital markets ranged between 89.3 and 118.9.⁴⁵ This is high in light of the fact that average scores during healthy economic times are normally between 100 and 110.⁴⁶ In late 2007 through 2008, the investor confidence index began to show a dramatic decline.⁴⁷ This dramatic decline in investor confidence correlates to the beginning of the current financial crisis.⁴⁸ In October 2008 alone, the index of North American investors declined 25.1 points to an all time low of 50.8.⁴⁹ This was an “unprecedented decline in investor confidence to a new record low, led by investors in North America.”⁵⁰

42. *Id.* “[T]he poll of its members by the American Association of Individual Investors is considered to be at extreme pessimism whenever the poll shows bearishness has risen to more than 55%, and bullishness has dropped below 25%.” *Id.*

43. *See generally* STATE STREET, INVESTOR CONFIDENCE INDEX SUMMARY (2008).

The State Street Investor Confidence Index® measures the attitude of investors to risk. The Index uses the principles of modern financial theory to model the underlying behavior of global investors. The Index provides a quantitative measure of the actual and changing levels of risk contained in investment portfolios representing about 15% of the world’s tradable assets.

Id. at 5.

44. Press Release, State Street, Investor Confidence Index Declines from 75.7 to 58.2 in October (Oct. 21, 2008), *available at* http://pr.statestreet.com/us/en/20081021_1.html [hereinafter Press Release, State Street].

45. STATE STREET, INVESTOR CONFIDENCE INDEX HISTORICAL DATA 1, http://www.statestreet.com/industry_insights/investor_confidence_index/ici_overview.html (last visited Apr. 19, 2010).

46. *See id.* (when the economy was relatively healthy in 2003–2005 averages tended to range between these numbers).

47. *Id.*

48. *See* Krassimir Petrov, *Current Economic Crisis Worse than the Great Depression*, MARKET ORACLE, Nov. 2, 2008, <http://www.marketoracle.co.uk/Article7099.html> (discussing the beginning of the current financial crisis).

49. Press Release, State Street, *supra* note 44.

50. *Id.*

Capping the liability of auditors at a time when accurate reports are necessary could worsen this precipitous drop in investor confidence and have further devastating effects. This decrease in investor confidence was likely caused by the domestic financial crisis, followed by the spread of these effects globally.⁵¹ It is the fear that domestic and international capital markets have entered into a recession that has, and will continue to, decrease investor confidence a great deal.⁵² The United States' position as a leader of the global economy could be at stake if the capital markets are not revived with new investments.⁵³ Foreign leaders have questioned whether the U.S. dollar should remain in the prominent position it currently holds in the global economy.⁵⁴ While this is mere speculation, it is worth noting that fast resolution and revival of our capital markets through increased investor confidence and investment could very well be the best way to ensure our position as a global economic leader.⁵⁵

II. THE EVOLUTION OF AUDITOR REGULATION AND LEGISLATION & THE CURRENT REGULATORY REGIME

An earlier financial crisis, the Great Depression, sheds light upon the origins of the role of the external auditor.⁵⁶ Following World War I, the economy of the United States was strong and many individuals began to invest their money in publicly traded companies.⁵⁷ During this surge of investment activity, there was little federal regulation of the securities markets.⁵⁸ While many proposals that called for the federal government to oversee the sale of stocks and to regulate financial disclosure were made, it was rare that they were ever taken seriously.⁵⁹ The major focus of both the government and business at the time was on turning a profit.⁶⁰

Early investment in the stock market was very speculative in nature and had many systemic problems because corporations wanted capital without

51. *Id.*

52. See Prieur du Plessis, *Fear Grips Stock Markets as Economies Tip into Recession*, MARKET ORACLE, Oct. 5, 2008, <http://www.marketoracle.co.uk/Article6631.html>.

53. Thomas Omestad, *Does Financial Crisis Threaten America's Central Role in Global Economy?*, U.S. NEWS & WORLD REP., Oct. 10, 2008, <http://www.usnews.com/articles/news/2008/10/10/does-financial-crisis-threaten-americas-central-role-in-global-economy.html>; Brown & Lundblad, *supra* note 1.

54. See Mark Deen & Isabelle Mas, *India Joins Russia, China in Questioning U.S. Dollar Prominence*, BLOOMBERG, July 4, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aR7yfqUwTb4M#>.

55. See Omestad, *supra* note 53.

56. See William R. Pape and Robert Sadler, *Adding Traceability Review to the External Audit (Packing and Food Safety)*, ENTREPRENEUR.COM, Sept. 2008, <http://www.entrepreneur.com/tradejournals/article/print/186284581.html>.

57. See Harold Bierman, Jr., *The 1929 Stock Market Crash*, EH.NET ENCYCLOPEDIA (2008), <http://eh.net/encyclopedia/article/Bierman.Crash>.

58. SEC, *supra* note 22.

59. *Id.*

60. *Id.*

regulation and eager investors were willing to invest their money regardless of whether the market was properly regulated.⁶¹ Corporations artificially inflated stock prices to make them appear more desirable and lenders artificially inflated interest rates as well.⁶² There was also an increase of purchasing stocks on margin, which facilitated the “final expansion and crash of the stock market.”⁶³ Common sentiment at the time was that eagerness and optimism had created an “exaggerated balloon of American stock values.”⁶⁴ Many media outlets, as well as government officials, began to see that the stock was excessively inflated, and started to make public statements which ignited fears that the stock was in fact overvalued.⁶⁵ These statements led to a panic and investors began to sell their stock rapidly,⁶⁶ eventually causing the 1929 stock market crash and the Great Depression that followed.⁶⁷

The Great Depression wreaked havoc on the American economy and necessitated a national solution to revive the capital markets. With over 25 billion dollars of worthless stock in their possession in the beginning of the 1930s,⁶⁸ it is no surprise that investor distrust of the market was rampant. Many Americans, individual investors, banks, and corporations feared for the future of the nation’s financial state.⁶⁹ The idea of federal regulation of the booming securities market was never popular, but the national scope of this crisis required a national solution.⁷⁰ Solving the financial crisis fell on the shoulders of Congress, the national body best suited to perform the research necessary to fashion a solution.⁷¹

In light of the Great Depression, Congress immediately began holding hearings with the intention of determining the quickest and most effective solution to restore the financial markets.⁷² “There was a consensus that for the economy to recover, the public’s faith in the capital markets needed to

61. *Id.*; see also Bierman, *supra* note 57; Steven Ramirez, *Securities Exchange Act of 1934*, ENOTES.COM, <http://www.enotes.com/major-acts-congress/securities-exchange-act>.

62. Bierman, *supra* note 57.

63. See Gene Smiley & Richard H. Keehn, *Margin Purchases, Brokers’ Loans and the Bull Market of the Twenties*, 2 BUS. & ECON. HISTORY 17, 129, 139 (1988) (noting that while the role of buying on margin as a cause of the Great Depression may often be “overstated,” it is undeniable that the ability to purchase stocks on margin facilitated the expansion and depth of the consequences of the Great Depression).

64. Bierman, *supra* note 57, at 1–2 (quoting ECONOMIST 806 (Nov. 2, 1929)).

65. *Id.* at 6.

66. *Id.*

67. *Id.*

68. SEC, *supra* note 22.

69. *Id.*

70. *Id.*

71. *Id.* This was a national depression with national consequences; thus, the goal of Congress was to fashion a national response that would create uniform rules of fair dealing across the country and protect investors nationally, as opposed to *ad hoc* measures taken by individual states or exchanges. *Id.*

72. *Id.*

be restored.”⁷³ This would prove to be a daunting task, as it was at the hands of these very markets that many Americans lost exorbitant portions of their personal wealth.⁷⁴

Within several years, Congress began to construct a legislative solution to restore the economy. The national legislative effort to restore the capital markets began with the Securities Act of 1933, followed with the Securities Exchange Act of 1934, and culminated with the creation of the SEC.⁷⁵ The goal of the SEC was to “restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing.”⁷⁶ This was accomplished through two major initiatives. First, all companies that offered securities for public investment would be required to make the public aware of their financial state, the particular types of securities they are selling, and the risks that will be involved with the particular investment.⁷⁷ Second, all individuals involved in the financial markets, including brokers, bankers, dealers, and the exchanges themselves, were required to treat investors honestly and make the individual investor their paramount concern.⁷⁸

The primary way that the SEC attains these goals is through the free flow of information transmitted to the public through various reporting requirements that publicly traded corporations were required to complete.⁷⁹ One way that the SEC ensures the accuracy of information that is disclosed by a corporation is through mandatory external audits.⁸⁰ Once companies fulfill the various disclosures necessary to inform the shareholder of their financial status, an external accountant must audit the forms.⁸¹ The accountant is then required to attest to the validity of these statements upon reasonable inspection of the company’s financial health.⁸² This is the origin of the role of the auditor in American finance as a means of increasing investor confidence in our capital markets.⁸³

73. *Id.* at 3.

74. See *The Stock Market Crash of 1929*, MONEY ALERT, <http://www.themoneyalert.com/stockmarketcrashof1929.html> (discussing the effects that the Great Depression had on consumers and the fact that many Americans lost their entire life savings as a result of the Stock Market Crash).

75. SEC, *supra* note 22.

76. *Id.*

77. *Id.*

78. See *id.*

79. *Id.*; see also Securities Act of 1933, 15 U.S.C. § 77a (2006) (the Securities Act of 1933 created the various reporting requirements that publicly traded corporations are now required to comply with).

80. Securities Act of 1933, 15 U.S.C. § 77s (2006).

81. Lynn E. Turner, Chief Accountant, SEC, Speech sponsored by Washington University School of Law and the Institute for Law and Economic Policy, Scottsdale, Arizona: Audit Committees: A Roadmap for Establishing Accountability (Mar. 10, 2001), available at <http://www.sec.gov/news/speech/spch469.htm>.

82. 15 U.S.C. § 77s.

83. See SEC, *supra* note 22.

While it is beyond the scope of this note to discuss in detail, many parallels exist between the post-Great Depression era and the financial thinking that accompanied it, and the current economic climate that America faces today.⁸⁴ Distrust of capital markets is just as apparent now as it was in the 1930s, and the method of getting out of this economic crisis, beyond government intervention, is largely based on continued investment and spending by individual investors as it was then.⁸⁵ It is for this reason that this note focuses on the need to revisit the same goal of increasing investor confidence and the crucial role that the external auditor plays in ensuring that corporations are honest with their potential investors that the SEC expounded over seventy years ago. Without promoting continued investor confidence through the role of the external auditor—and the investments that will follow—it is possible that the effects of the current financial crisis could be worse than the Great Depression.⁸⁶

While the role of the auditor helped to increase investor confidence for a period of time, within several decades, fraud and financial misstatements became an issue once again.⁸⁷ The Enron scandal is another crisis that revolutionized the role of the external auditor.⁸⁸ During the 1990s, there were multiple instances of accounting fraud, most of which were on a massive scale.⁸⁹ “Some of these instances of frauds were undertaken in conjunction with the external auditors of the companies involved.”⁹⁰ This massive corporate accounting fraud involved corporations such as Enron, MCI, Inc., Tyco, Qwest, Adelphia Communications, and Global Crossing.⁹¹ Investors quickly lost confidence in the capital markets when such orchestrated, large-scale frauds were revealed in many large corporations.⁹² While not all of these scandals directly involved auditors as the Enron scandal did, many involved auditor oversight, at least tangentially.⁹³

With the financial disclosure requirements developed by the SEC beginning to fail investors once again, and distrust of the capital markets

84. James Quinn, *America's Economic Collapse: The Gathering Storm—Is Another Great Depression Approaching?*, CUTTING EDGE, Oct. 13, 2008, <http://www.thecuttingedge.com/index.php?article=826>.

85. *Id.*

86. Petrov, *supra* note 48.

87. See Uma D. Sridharan et al., *The Social Impact of Business Failure: Enron*, 17 AM. J. BUS. 2, 12 (2002), available at <http://www.bsu.edu/mcobwin/majb/?p=199>.

88. See generally Gideon Mark, *Accounting Fraud: Pleading Scierter of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097 (2007).

89. *Id.* at 1099.

90. *Id.* at 1099–1100.

91. Huck Gutman, *Dishonesty, Greed and Hypocrisy in Corporate America*, <http://www.commondreams.org/views02/0712-02.htm>.

92. *Id.*

93. Richard A. Oppel, Jr. & Kurt Eichenwald, *Enron's Collapse: The Overview; Arthur Andersen Fires an Executive for Enron Orders*, N.Y. TIMES, Jan. 16, 2002, available at <http://www.nytimes.com/2002/01/16/business/enron-s-collapse-overview-arthur-andersen-fires-executive-for-enron-orders.html?pagewanted=all>.

and big business growing exponentially, another national solution became necessary to restore investor confidence and promote investment in our capital markets.⁹⁴ Thus, the Sarbanes-Oxley Act (SOX) was enacted in 2002.⁹⁵ “[SOX] put a necessary spotlight on corporate governance and financial reporting.”⁹⁶

In addition, SOX “called for the most significant reforms affecting our capital markets since the Securities Exchange Act of 1934.”⁹⁷ Indeed, SOX dealt with the role of auditors as well as the general disclosure required by corporations.⁹⁸ SOX was the culmination of over thirty bills that Congress enacted in order to revamp financial reporting, accounting, and retirement accounts.⁹⁹ Due to SOX, “[a]uditors must now face significant changes in the regulatory landscape wrought by [SOX] as well as a charged environment in which the SEC and others increasingly view independent auditors as prime targets.”¹⁰⁰

To these ends, SOX was created with four major goals: “[1] [T]o improve corporate governance and ‘the tone at the top’ of a publicly [traded] company . . . [2] to strengthen financial reporting and disclosure . . . [3] to improve corporate internal controls and auditor performance [and] . . . [4] to create a tougher enforcement environment for the [SEC] to oversee.”¹⁰¹

One of these significant changes was the ability of the SEC to censure an accountant serving as an external auditor who lacks character and integrity, engages in unethical or improper conduct, or who willfully violated, or assisted in the violation of, any securities provision.¹⁰² SOX also altered the statute of limitations for securities fraud claims, making the period within two years after the discovery of the fraud but no more than five years after the actual fraud took place.¹⁰³ SOX also made it a felony to

94. *The Dramatic Change Across the Corporate Landscape to Re-Establish Investor Confidence in the Integrity of Corporate Disclosures and Financial Reporting: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. 178–79 (2003) [hereinafter *Hearings on Re-establishing Investor Confidence*] (prepared statement of John J. Castellani, President, The Business Roundtable) (discussing national legislative efforts to restore investor confidence).

95. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, & 29 U.S.C.).

96. *Hearings on Re-Establishing Investor Confidence*, *supra*, note 94, at 154.

97. *Impact of the Sarbanes-Oxley Act: Hearing Before the H. Comm. on Financial Services*, 109th Cong. 44 (2005) (testimony of William H. Donaldson, Chairman, SEC).

98. Edward P. Leibensperger & Lauren M. Papenhausen, *Auditor Liability for Securities Fraud After the PSLRA and Sarbanes-Oxley*, in *SECURITIES LITIGATION PLANNING AND STRATEGIES—THE TIME IS NOW!* 541, 543 (A. L. I.—A.B.A. Course of Study, May 8–9, 2002).

99. *Id.* at 543.

100. *Id.*

101. Thomas C. Pearson & Gideon Mark, *Investigations, Inspections, and Audits in the Post-SOX Environment*, 86 NEB. L. REV. 43, 45–46 (2007).

102. The Sarbanes-Oxley Act of 2002, 15 U.S.C. § 78d-3 (2006).

103. The Sarbanes-Oxley Act of 2002, 28 U.S.C. § 1658 (2006).

destroy financial and auditing records, as well as failing to properly maintain such records.¹⁰⁴ Auditors are no longer allowed to offer other non-audit related services to the corporations that they audit.¹⁰⁵ Section 204 of SOX also requires that the auditor report to the Audit Committee the practices they use during their audits, suggestions they have made to management of the corporation, and all of their communications with management during the auditing period.¹⁰⁶ Auditors must now attest to the reports that they file as well as their assessment of the state of the corporation, making themselves individually liable for the validity of the reports.¹⁰⁷ The extensive regulation that SOX has focused on auditors illustrates the importance that the SEC places on the role of the external auditor as a means of furthering the goal of increasing investor confidence.

Further regulating the important role of the external auditor, SOX created the Public Company Accounting Oversight Board (PCAOB), which falls under the oversight powers of the SEC.¹⁰⁸ The PCAOB is a further effort to ensure that fraud does not continue at the level of the external auditor.¹⁰⁹ It serves several functions, namely to:

- (1) register public accounting firms that prepare audit reports for issuers . . . ;
- (2) establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers, in accordance with [§] 103;
- (3) conduct inspections of registered public accounting firms, in accordance with [§] 104 and the rules of the Board;
- (4) conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms . . . ;
- (5) perform such other duties or functions as the Board (or the Commission, by rule or order) determines are necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof, or otherwise to carry out this Act, in order to protect investors, or to further the public interest;

104. The Sarbanes-Oxley Act of 2002, 18 U.S.C. § 1519 (2006).

105. The Sarbanes-Oxley Act of 2002, 15 U.S.C. § 78j-1(g) (2006).

106. *Id.* § 78j-1(k).

107. *Id.* § 7261.

108. Jaclyn Jaeger, *Battle Continues Over PCAOB and SOX Future*, COMPLIANCE WK., Dec. 15, 2009, <http://www.complianceweek.com/article/5718/battle-continues-over-pcaob-and-sox-future>.

109. Sarah Q. Wirsky, *Sarbanes-Oxley: The New Corporate Standards*, PETROLEUM ACC. & FIN. MGMT. J., Summer 2003, at 1.

(6) enforce compliance with this Act, the rules of the Board, professional standards and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, by registered public accounting firms and associated persons thereof¹¹⁰

Taken as a whole, SOX clearly places more responsibility on auditors who once were able to place the blame on a particular corporation.¹¹¹ SOX has made it painfully clear that government regulators believe that the auditor's role of gatekeeper is of the utmost importance and will no longer be taken lightly.¹¹²

The impact of SOX has been "largely positive" and it has had a significant impact on the confidence that investors have in the capital markets.¹¹³ In 2004 alone, stock exchanges' total market capitalizations increase by 50%.¹¹⁴ This statistic shows an increase in investor confidence in the market in the post-Enron period, and a willingness of individual investors to put their money back into the capital markets.¹¹⁵ The post-SOX era has seen an increase in conservative filings by corporations in an effort to ensure that financial statements are as accurate as possible.¹¹⁶ There has also been a decrease in the number of accounting restatements that are filed, which most likely means that original statements that are being produced by corporations are more accurate the first time around, one of the primary goals of SOX.¹¹⁷

SOX is also credited with strengthening the integrity of the independent audit and the value that external audit reports have.¹¹⁸ There has been vast improvement in overall disclosure and financial reporting done by publicly traded companies, with an effective system of control and enforcement to ensure compliance with SOX and the SEC principles in general.¹¹⁹ Auditors have stated that the industry has become more diligent and active, that the

110. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7211(c) (2006).

111. See Colin Linsley, *Auditing, Risk Management and a Post Sarbanes-Oxley World (Sarbanes-Oxley Act of 2002)*, ENTREPRENEUR.COM, Fall 2003, <http://www.entrepreneur.com/tradejournals/article/print/111508706.html>.

112. *Id.*

113. *Sarbanes-Oxley at Four: Protecting Investors and Strengthening Markets: Hearing Before the H. Comm. on Financial Serv.*, 110th Cong. 56–61 (2006) (testimony of Christopher Cox, Chairman, SEC).

114. Alyssa Machold Ellsworth, Managing Dir., Council of Institutional Investors, Federal News Service, Remarks at U.S. News & World Reports National Issue Briefing: Corporate America and Congress: Has Sarbanes-Oxley Increased Investor Confidence? (Oct. 5, 2005), available at www.law.harvard.edu/programs/olin_center/corporate_governance/MediaMentions/USNews_10.05.05.pdf.

115. *See id.*

116. Gerald J. Lobo & Jian Zhou, *Did Conservatism in Financial Reporting Increase After the Sarbanes-Oxley Act? Initial Evidence*, 20 ACCT. HORIZONS 1, 18 (2006).

117. *Id.*

118. Leibensperger & Papenhausen, *supra* note 98, at 559.

119. *Id.*

expertise in the industry has largely improved with the personal liability that SOX has required the auditors to take on,¹²⁰ and that it has become easier for them to successfully complete their tasks with the corporate governance that is in place, as it is easier for them to get the information necessary for their reports.¹²¹ There has also been increased cooperation with the internal and external auditors that helps to promote the overall goal of SOX: to increase the validity of statements regarding the financial state of corporations.¹²²

However, while SOX has been heralded as an effective piece of legislation used to encourage auditors to take their role as gatekeepers seriously, it has also been highly criticized.¹²³ The first criticism that is commonly offered is that excessive costs are necessary to comply with SOX reporting requirements.¹²⁴ There are a variety of external costs that have developed, and because of the importance and necessity of external auditors in the post-SOX era, auditors have raised their prices dramatically.¹²⁵ Specifically, in 2005, auditors raised prices by up to 58%.¹²⁶ There have been many auditor dismissals in the post-SOX era, largely because many corporations are not willing to pay these high costs.¹²⁷ Some of the Big Four's¹²⁸ clients have attempted to replace their original auditors with more affordable alternatives.¹²⁹ Yet, overall, publicly traded corporations have an undeniable preference for one of the Big Four, as a result of their technical skills, reputation, and capacity.¹³⁰

One of the most pertinent criticisms of SOX is the increased legal liability that auditors now face as secondary actors in corporate fraud.¹³¹

120. Jeffrey Cohen et al., *Corporate Governance in the Post Sarbanes-Oxley Era: Auditors Experience*, CONTEMP. ACCOUNT. RES. (forthcoming) (manuscript at 5), available at <http://papers.ssrn.com/abstract-1014029>.

121. *Id.* (manuscript at 18).

122. *Id.*

123. *Sarbanes-Oxley Act Improves Investor Confidence, But at a Cost*, C.P.A. J., Oct. 2005, <http://www.nysscpa.org/printversions/cpaj/2005/>.

124. *Id.*

125. *Id.*

126. *Id.*

127. See generally Michael L. Ettredge et al., *Audit Fees and Auditor Dismissals in the Sarbanes-Oxley Era*, 21 ACCT. HORIZONS 4 (Dec. 2007).

128. The "big four" are the four largest accounting firms of PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young, and KPMG, "who audit nearly all the world's biggest companies . . ." See Jennifer Hughes, *EU Calls for Limits to Auditors Liability*, FIN. TIMES, at 5, June 7, 2008.

129. Ettredge et al., *supra* note 127.

130. General Accounting Office Reports & Testimony, *Accounting Firm Consolidation: Selected Large Public Company Views on Audit Fees, Quality, Independence and Choice*, ALLBUSINESS.COM, Sept. 30, 2003, <http://www.allbusiness.com/public-administration/executive-legislative-other/669034-1.html>; see also Talia Zubli, *Solving the Problem of Unlimited Auditor Liability*, FIN. DIR., Apr. 23, 2007, <http://www.the-financedirector.com/features/feature941/>.

131. Kimberly Brame, *Beyond Misrepresentations: Defining Primary and Secondary Liability Under Subsections (A) and (C) of Rule 10-B-5*, 67 LA. L. REV. 935, 935 (2007).

Because auditors are legally required to verify that the reports they create are accurate and truthful, they can now be held legally liable, both civilly and criminally, for failure to honestly comply with this verification requirement.¹³² Litigation has proliferated extensively in the post-SOX era. “Soaring litigation, settlement costs, and insurance costs have reinforced the need for greater quality in corporate governance, financial reporting, external audits, and government enforcement of the securities law.”¹³³ This liability has provided major momentum towards auditor liability reform.¹³⁴ It is important to remember, however, that when auditors comply with the law, comply with the Generally Accepted Accounting Principles (GAAP) proscribed by PCAOB, and do not involve themselves with fraud, potential liability is minimal, if not nonexistent.¹³⁵

III. AUDITOR LIABILITIES IN OUR CURRENT LEGISLATIVE CLIMATE

Establishing the liability of external auditors who report on the financial health of a company is one of the tools the SEC has employed to increase investor confidence, but it has not come without costs.¹³⁶ While it is true that prior to SOX auditors faced legal liabilities, SOX has increased the liabilities that auditors face, as they are now required to attest to the validity of the statements provided by corporations.¹³⁷ This liability is a means of ensuring that auditors will be careful and accurate when reviewing financial statements.¹³⁸

The magnitude of the liabilities that auditors face is best evidenced by particular lawsuits. “In the first quarter of [2008], PwC [PricewaterhouseCoopers] settled three lawsuits[:] Metropolitan Mortgage and SmarTalk Teleservices each for about \$30 million, and Crocus venture capital, for \$6.1 million.”¹³⁹ This is only a representative sample of the liabilities that auditors have faced.¹⁴⁰ In December of 1999, Ernst & Young settled with the shareholders of Cendant for a total of \$335 million.¹⁴¹ Ernst

132. Lisa McCauley-Parles et al., *Sarbanes-Oxley: An Overview of Current Issues and Concerns*, ENTREPRENEUR.COM, Mar. 22, 2007, <http://www.entrepreneur.com/tradejournals/article/165359568.html>.

133. Pearson & Mark, *supra* note 101, at 61.

134. See Leibensperger & Papenhausen, *supra* note 98, at 543.

135. See generally Marleen Willekens & Dan A. Simunic, *Precision in Auditing Standards: Effects on Auditor and Director Liability and the Supply and Demand for Audit Services*, 37 ACCT. & BUS. RES. 3 (2007).

136. *Sarbanes-Oxley Act Improves Investor Confidence, But at a Cost*, *supra* note 123.

137. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7262 (2006).

138. See *Sarbanes-Oxley Act Improves Investor Confidence, But at a Cost*, *supra* note 123.

139. Rick Telberg, *Top 10 Auditor Liability Settlements*, C.P.A. TRENDLINES, Apr. 15, 2008, <http://cpatrendlines.com/2008/04/15/top-10-auditor-liability-settlements/>.

140. *Id.*

141. Bernstein Litowitz Berger & Grossman L.L.P., *Ernst & Young Agrees to \$335 Million Settlement with Cendant Shareholders, According to Plaintiffs' Co-Counsel Bernstein Litowitz*

& Young was accused of failure to serve its function as watchdogs when three annual reports, seven quarterly reports, and over twenty registration statements were fraudulent.¹⁴² This purported failure to ensure that the financial statements were properly made along with the reports' fraudulent statements of the corporation's financial health is most likely what led to the settlement.¹⁴³

Another large settlement occurred in the litigation between the shareholders of Rite-Aid Corporation (Rite-Aid) and KPMG. KPMG agreed to pay \$125 million to the shareholders as part of the Stipulation of Settlement.¹⁴⁴ KPMG allegedly failed to accurately police Rite-Aid's 1999 restatement of earnings which contained fraudulent information.¹⁴⁵ While District Judge Dalzell stated that this was a "difficult case," as it was very possible that KPMG itself was a victim as well as the shareholders, the fact that KPMG settled shows the stringent liabilities that auditors truly face.¹⁴⁶

This is the exact type of fraud and oversight that the SEC, through SOX, has been attempting to prevent.¹⁴⁷ The immense legal liabilities that auditors face exist because it is necessary to hold them liable in order to increase investor confidence.¹⁴⁸ To cap liability when mistakes like this are still occurring is simply giving auditors a license to be less careful.

While paying these large settlements is a testament to the liabilities that accounting firms face, nothing speaks more obviously to the threat these liabilities pose than the collapse of Arthur Andersen. Arthur Andersen was Enron's accounting firm, and, at the time, was the fifth largest accounting

Berger & Grossman LLP and Barrack, Rodos & Bacine, BNET.COM, Dec. 17, 1999, available at http://findarticles.com/p/articles/mi_m0EIN/is_1999_Dec_17/ai58295570/?tag=content;coll.

142. *Id.*

143. *See id.*

144. *Second Largest Accounting Firm Settlement Ever*, 10B-5 DAILY, June 2, 2003, <http://www.the10b-5daily.com/archives/000132/html>. KPMG, of the United States, together with its Belgium counterpart, was also forced to settle for \$115 million in a lawsuit brought against them by the shareholders of Lernout & Hauspie Speech Products, N.V., a Belgium software company. *Investors Reach \$115 Million Settlement with accounting Firms Klynveld Peat Marwick Goerdeler Bedrijfsrevisoren and KPMG L.L.P., Berman Devalerio Pease Tabacco Burt & Pucillo Announces*, BNET.COM, Oct. 7, 2004, http://findarticles.com/p/articels/mi_m0EIN/is_2004. The corporation was charged with using "every accounting trick in the book" to attempt to defraud their investors through accounting reports. *Id.* These procedures eventually resulted in the company going bankrupt and the shareholders losing their investments in the corporation. *Id.* The stock had been artificially inflated, which is what led to the bankruptcy, and KPMG failed to either notice or report the fraudulent statements and reports, resulting in their liability, and pushing them to settle. *See id.*

145. *Second Largest Accounting Firm Settlement Ever*, *supra* note 144.

146. *See id.* Other notable settlements in the United States are as follows: Deloitte settled with Fortress Re. in 2005 for \$250 million; PricewaterhouseCoopers settled with Tyco shareholders for \$225 million in July of 2007; Arthur Andersen settled with the Baptist Fund of Arizona for \$217 million in 2002; and Deloitte settled with Adelphia for \$210 million in November of 2006. Telberg, *supra* note 139.

147. McCauley-Parles et al., *supra* note 132.

148. *See id.*

firm in the world.¹⁴⁹ Although their liability in the Enron scandal was dismissed by the Supreme Court in 2005, the wake of the Enron scandal left the firm unable to survive.¹⁵⁰ Clients began to flee for fear that the firm was unable to serve its role as gatekeeper, which, when coupled with the firm's legal liabilities, led to the firm's demise.¹⁵¹

The implosion of Arthur Andersen in 2002 sparked the beginning of a push towards restricting the liability that accounting firms face.¹⁵² Many auditors argue that there is a definite risk that more firms could implode in the near future in light of the liabilities that accounting firms face.¹⁵³ Thus far, auditors have been unable to gain outside insurance for these liabilities.¹⁵⁴ While they have attempted self-insurance through wholly-owned insurance companies, it is not clear that these insurance attempts will be sufficient to protect auditors.¹⁵⁵

Auditors arguing for a cap on liability share the same concerns. The fear is that the liability that auditors currently face could result in the collapse of another major auditing firm.¹⁵⁶ The auditor lobby argues that while the role of private litigation is important in capital markets, there should be "concern over rising litigation costs, 'mega' suits, and pressure on audit firms to settle cases instead of litigating them."¹⁵⁷ Various actors have "moved in numerous ways to place enhanced scrutiny on the financial reporting and controls practices within publicly traded firms. Amid this flurry of activity . . . [a]uditors now face enhanced vulnerability to liability risks that—at least according to some—threaten the . . . viability of the industry as we know it."¹⁵⁸ However, the increased liability auditors now complain of is the precise liability we want them to face. "The tort system is designed to create incentives for auditors to take appropriate actions to minimize the issuance of misleading financial statements and to compensate users for their recoverable losses" should the auditor fail to properly perform its duties.¹⁵⁹ Removing potential liability will not further the goal of increasing investor confidence through valid and thorough information,

149. Economist.com, Research Tools Backgrounders: Arthur Andersen, July 7, 2005, http://www.economist.com/background/displayBackground.cfm?story_id=4033756.

150. *Id.*

151. *Id.*; see also Flynn McRoberts, *A Final Accounting: The Fall of Andersen*, CHICAGO TRIB., at 1, Sept. 1, 2002 (discussing the collapse of Arthur Andersen and the effect that the Enron liability had on the corporation).

152. See Mark, *supra* note 88.

153. Eric L. Talley, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 COLUM. L. REV. 1641, 1643 (2006).

154. *Id.* at 1643.

155. *Id.* at 1642.

156. James H. Irving et al., *supra* note 27.

157. *Id.* at 2.

158. Talley, *supra* note 153, at 1642.

159. Irving, *supra* note 27, at 4.

as the very mechanism designed to ensure accuracy will be largely diminished.

While shareholders bringing federal securities class actions are understandably a potential cause of the demise of one of the Big Four auditors, there are other liabilities that auditors face in relation to their role as gatekeepers. An auditor could potentially implode as a result of losing its ability to practice following criminal sanctions.¹⁶⁰ Money sanctions and penalizations imposed in both civil and criminal litigation could also bring about the potential collapse of an accounting firm.¹⁶¹ And finally, auditors face the threat of federal securities class action lawsuits—the impetus behind the efforts to cap liability.¹⁶²

In light of these liabilities, the Big Four accounting firms have decided to lobby for a cap on the potential liabilities they could face, and have also attempted to use contractual clauses to shield themselves.¹⁶³ The Big Four are asking the firms they audit to limit their right to sue, and to waive their right to punitive damages.¹⁶⁴ While this will only cap corporations' ability to sue, it does have the potential to save the accounting firms the large sums of money they are forced to pay to the corporations.¹⁶⁵ Even though auditors will still face liability to the shareholders that bring federal securities class actions, the agreements attempt to bar derivative suits.¹⁶⁶ Various complaints have been made by investors who argue that these agreements may violate SEC rules, and that the provisions overall are too self-interested and against the SEC principal of putting the investor first.¹⁶⁷ Auditors have also attempted to further alter their liability, without government assistance, through contract law, by including arbitration clauses, indemnity and hold-harmless provisions, and other similar protections in their dealings with clients.¹⁶⁸

IV. PROPOSALS FOR REFORMING AUDITOR LIABILITY

While calls for limiting auditor liability are not novel, they are starting to gain attention in the United States.¹⁶⁹ At the same time they are growing

160. Talley, *supra* note 153, at 1648.

161. *Id.*

162. *Id.*

163. *Id.* at 1642; Robert Schmidt, 'No Suit' Accounting Contracts Set Off Alarms, INT'L HERALD TR., at 20, Dec. 13, 2005.

164. Schmidt, *supra* note 163.

165. Robert Schmidt, *Ernst, KPMG Liability Caps Draw Fire from Regulators, Investors*, BLOOMBERG, Dec. 12, 2005, <http://www.bloomberg.com/apps/news?pid=10000103&sid=aVGCZaozSkAI>.

166. *Id.*

167. *Id.*

168. Talley, *supra* note 153, at 1642.

169. See Penny Sukhraj, *FRC Appeals to US Watchdog Over Auditor Liability Deals*, ACCOUNTANCY AGE, at 2, June 12, 2008, available at <http://www.accountancyage.com/2218842>.

increasingly popular in the European Union (E.U.).¹⁷⁰ The Financial Reporting Council (FRC) claims that it is playing the leading role in persuading the SEC to create a limitation to the liability that auditors face in light of this trend taking hold in other parts of the global economy.¹⁷¹

The Big Four argue that any efforts in the United Kingdom (U.K.) to cap liability must coincide with efforts to limit liability in the U.S. and Europe alike, in order to deal with the many corporations that are listed in more than one nation.¹⁷² In the U.K. auditors may limit liability contractually, provided the shareholders approve it,¹⁷³ but “cannot enter into such arrangements . . . with clients who either dual-listed shares, or listed debt in the [U.S.] since it would constitute a breach of [U.S.] auditor-independence rules.”¹⁷⁴ Therefore, a failure to limit auditor liability in the U.S. would essentially halt any attempts to limit auditor liability in the U.K.¹⁷⁵ Corporations listed solely in the U.K. are unlikely to accept capping the liability of their auditors if the corporations that are bi-listed do not have to.¹⁷⁶ This would effectively reverse any advances that auditor liability reforms in the U.K. have made to limit liability through shareholder agreements.¹⁷⁷

Several groups in the United States are faced with the daunting task of developing compelling proposals to cap auditor liability in the United States, despite the fact that the liability exists as a means of ensuring that auditors properly perform their role. Arthur Levitt, the former SEC Chairman, is currently leading a committee charged with the task of digesting close to twenty different reports on the potential ways to solve the supposed auditor liability problem in the United States.¹⁷⁸ Although many proposals have been offered, the U.S. Treasury is not taking the pro-cap stance that the accounting lobby would have hoped for.¹⁷⁹ Reforms limiting the auditors’ liability in litigation have not even been addressed by the U.S. Treasury or the SEC.¹⁸⁰

170. *See id.*

171. *Id.*

172. Neil Hodge, *Limiting Auditor Liability*, WORLD FIN., Nov. 14, 2008, available at <http://www.worldfinance.com/magazinearticles/article388.html>.

173. Sukhraj, *supra* note 169.

174. *Id.*

175. Penny Sukhraj, *Will the US Say Yes?*, ACCOUNTANCY AGE, July 3, 2008, <http://www.accountancyage.com/220589>.

176. *Id.*

177. *See id.*

178. Press Release, U.S. Dep’t of Treasury, Treasury Advisory Committee on the Auditing Profession Adopts Final Report (Sept. 26, 2008), <http://www.ustreas.gov/press/releases/hp1159.htm>; The Corporate Counsel, <http://www.thecorporatecounsel.net/blog/archive/> (Apr. 22, 2008, 06:10 EST) (edited by Broc Romanek & David Lynn).

179. Penny Sukhraj, *US Auditors Call for Urgent Action on Liability Reform*, ACCOUNTANCY AGE, Sept. 4, 2008, <http://www.accountancyage.com/2225313>.

180. *Id.*

Further supporting the push to limit the liability of auditors is the Paulson Committee Report, also known as the Committee on Capital Markets Regulation.¹⁸¹ The Committee on Capital Markets Regulation is “an independent and nonpartisan 501(c)(3) research organization dedicated to improving the regulation of U.S. capital markets.”¹⁸² The Paulson Report speaks to the impairment that the corporate world would face if another accounting firm collapses in the near future in light of growing auditor liability.¹⁸³ In particular, the report stated that “there are more than three dozen cases involving tens of billions of dollars of potential exposure to accounting firms, and expressed the concern that even a relatively small share of proportional liability in these cases may lead to the financial failure of one of the remaining firms.”¹⁸⁴ The report suggested potential aspects of the field which need to be reformed to protect the Big Four, including: (1) creating a legislative safe harbor for particular auditing practices that are used throughout the industry; (2) creating a legislative cap on the liability that auditors face; (3) appointing monitors to oversee auditing firms who have engaged in particular professional failures; (4) and restricting the criminal liability that auditors currently face in the post-SOX era.¹⁸⁵

There are several other committees in the U.S. that also promote a cap on liability. Keeping in line with the ideas of the Paulson committee, the Bloomberg-Schumer Report¹⁸⁶ also recommends a cap on auditor liability to maintain the auditing industry in the U.S. and prevent the failure of one of the Big Four.¹⁸⁷ The Commission on the Regulation of the U.S. Capital Markets in the 21st Century has reported on the risks which auditors face.¹⁸⁸

181. Posting of Josh Silverman to Pomtalk.com, http://www.pomtalk.com/pomtalk/2006/12/paulson_committ.html (Dec. 5, 2006, 10:22 EST).

182. Committee on Capital Markets Regulation, Home Page, <http://www.capmktreg.org/> (last visited Apr. 21, 2010).

183. Jonathan C. Dickey, *Auditor Liability “Caps” – The Politics of Catastrophe*, SEC. LITIG. REP., at 1, 5, Nov. 2008.

184. Jonathan C. Dickey, *Litigation Against Accountants & Lawyers: The Year of Living Dangerously 10* (17th Annual Litig. Resolution of Complex Class Actions Workshop, Paper, 2007), *available at* <http://www.gibsondunn.com/publications/Documents/Dickey-YearOfLivingDangerously.pdf>.

185. *Id.*

186. See MAYOR MICHAEL R. BLOOMBERG & SENATOR CHARLES E. SCHUMER, *SUSTAINING NEW YORK’S AND THE US’ GLOBAL FINANCIAL SERVICES LEADERSHIP* (2007), *available at* http://www.abanet.org/buslaw/committees/CL116000pub/materials/library/NY_Schumer-Bloomberg_REPORT_FINAL.pdf. The Bloomberg-Schumer report was created by New York City Mayor Michael Bloomberg and New York Senator Charles Schumer. *Id.* It warns that “if we do nothing, within ten years while we will remain a leading regional financial center; we will no longer be the financial capital of the world.” *Id.* at i. It finds, among other things, that the U.S. regulatory framework is a “thicket of complicated rules, rather than a streamlined set of commonly understood principles.” *Id.* at ii. It calls for re-examination of SOX implementation, legal reforms to reduce meritless litigation, and easing immigration restrictions. *Id.* at ii.

187. *Id.* at 102.

188. COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY, *REPORT AND RECOMMENDATIONS: AN EXECUTIVE SUMMARY* 16 (2007).

For their part, the SEC argues that we need to establish more realistic expectations of the abilities of auditors, encouraging

domestic and international market participants and policy-makers to engage immediately in a serious evaluation and discussion of possible means to address this risk of catastrophic loss [of a large public audit firm], including this Commission's recommendation regarding backup insurance sponsored by Group of Eight (G-8) governments or international financial organizations, and various proposals . . . regarding safe harbors or damage limits in specified circumstances.¹⁸⁹

Because of the global nature of our markets,¹⁹⁰ it is worth looking further at the E.U.'s move towards limiting the liability of auditors. The E.U. has come the furthest in developing plans to limit the liability of auditors, with several member states adopting legislation to this end.¹⁹¹ The E.U.'s proposals for limiting auditors' liability mirror plans being considered in the U.S.¹⁹²

The E.U. has taken several steps towards developing a European wide proposal to cap the liability that European auditors face.¹⁹³ An E.U. Commission has been researching the potential ways to cap the liability of auditors, and published a paper in 2007 that analyzed proposed means of capping liability as well as the potential liabilities auditors may be forced to deal with in the future.¹⁹⁴ The European push to cap auditor liability stems from a litigious climate very similar to that in the United States.¹⁹⁵ Europeans have similar concerns that one of the Big Four auditors there could collapse and create potentially negative effects on the economy.¹⁹⁶

The E.U. Commission has proposed four general plans to cap liability, and recognizes that due to differences in economies and financial markets in different nations, there is probably no "one-size-fits-all approach."¹⁹⁷ However, research and discussion of plans to cap auditor liability in the E.U. are more advanced than those in the U.S. and, as such, are worth discussing in more detail.¹⁹⁸ The four proposals are: (1) a fixed monetary cap;¹⁹⁹ (2) a cap based on the size of the company that was audited "as

189. *Id.* at 16–17.

190. SEC, *supra* note 22.

191. Talley, *supra* note 153, at 1642; Jeremy Woolfe, *Auditor Liability Debate Accelerates in EU*, COMPLIANCE WK. (Jul. 10, 2007).

192. Woolfe, *supra* note 191.

193. See Zubli, *supra* note 130.

194. *Commission Plans to Cap Auditors' Liability*, EURACTIV.COM, Jan. 19, 2007, http://www.euractiv.com/en/financial-services/commission-plans-cap-auditors-liability/article-161024?_print [hereinafter EURACTIV].

195. See generally *id.* (discussing "ruinous claims" auditors face in Europe).

196. *Id.*

197. *Id.*

198. Whitehouse, *supra* note 18.

199. Marianne Ojo, *Proposals for a New Audit Liability in Europe 4* (Mar. 23, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1407212.

measured by its market capitalization;²⁰⁰ (3) a cap which is established by calculating a multiple of the fees charged for the audit;²⁰¹ and (4) the principle of proportionate liability which holds each party (auditor and corporation) liable only for the portion of the loss that corresponds directly to their degree of responsibility and involvement.²⁰²

The fixed monetary cap on auditor liability is probably the most troubling plan, and garners the least support among interested parties.²⁰³ The fixed monetary cap establishes a monetary amount that will serve as a ceiling to all recoveries involving litigation against any accounting firm in connection with their auditing function.²⁰⁴ The goal of the fixed monetary cap is harmonization of E.U. policy, as all member states will have the same legislative cap in effect.²⁰⁵ The problems surrounding the fixed monetary cap largely revolve around the monetary value amount that will be selected by the legislatures.²⁰⁶ If the cap is too low, then even the maximum recovery may be unable to protect the largest, most highly capitalized corporations.²⁰⁷ If the cap is set very high, this will only work to protect the Big Four, as the smaller auditors that currently face liabilities as well will not be protected or shielded from the liability they face.²⁰⁸

While the criticisms to the fixed monetary cap are many,²⁰⁹ several European nations have enacted a legislative fixed monetary cap on auditor liabilities.²¹⁰ In December 2005, Belgium codified a law that created a fixed monetary cap,²¹¹ and established a monetary cap of €3 million for the audit of an unlisted company that is either required by statute or requested by a particular law or regulation, and a cap of €12 million for listed corporations.²¹² Coupled with this fixed monetary cap is a compulsory insurance policy, which ensures that coverage is in line with the potential liabilities that auditors can face in the new regime, guaranteeing that

200. *Id.*

201. *Id.*

202. *Id.*

203. Directorate General, *Summary Report*, *supra* note 16, 21–22.

204. See Walter Doralt et. al., *Auditors' Liability and Its Impact on the European Financial Markets*, 67 CAMBRIDGE L.J. 62, 64 (2008) (discussing the operation of a fixed monetary cap whereby a monetary value is set as a limit to the auditor's liability).

205. Letter from Grant Thornton Int'l, London Office, to the European Commission, (Mar. 15, 2007), available at <http://www.gti.org/files/covering%20letter%20ifrs%208%20questionnaire%20gti%2015%20june%202007.pdf>.

206. *Id.*

207. *Id.*

208. *Id.*

209. Directorate General, *Summary Report*, *supra* note 16, at 22.

210. Jeremy Woolfe, *EU Calls for Input on Auditor Liability Caps*, COMPLIANCE WK., Feb. 6, 2007, <https://www.complianceweek.com/article/3084/eu-calls-for-input-on-auditor-liability-caps>.

211. Directorate General for Internal Market and Services, *Commission Staff Working Papers: Consultation on Auditors' Liability and Its Impact on the European Capital Markets*, at 1 (Feb. 2007), available at http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/abschluss_sprfung/abschlussprfern/institute_registered/_EN_1.0_&a=d.

212. *Id.*

auditors are sufficiently insured.²¹³ The Directive General for Internal Market and Services of Belgium supports having fixed monetary caps throughout Europe, but agrees that this cannot be on an across the board basis and favors setting the cap at different levels depending on the particular member state.²¹⁴ Austria, Germany, and Greece²¹⁵ also have auditor liability caps that serve as a flat ceiling on potential recovery from a lawsuit.²¹⁶

While fixed monetary caps have been put into effect in several nations, they are still highly unpopular.²¹⁷ The first major issue is that a flat monetary cap will always be a one-size fits all approach.²¹⁸ Whether it is the E.U. or the U.S., different jurisdictions have a “diversity of circumstances in terms of both audits and company size . . . such that it is unlikely that a one-size-fits-all . . . approach is the most [appropriate].”²¹⁹ Beyond the inadequacy of the implementation of the policy is the underlying principle that the SECs purpose of making individuals personally liable was to ensure high-quality accurate work to promote investor confidence.²²⁰ “Limiting auditor liability would reduce auditor and audit firm accountability, provide a significant market incentive to take audit shortcuts, aggressive treatments, and reduce overall audit quality to the detriment of investors.”²²¹ This lack of accountability, and the resulting

213. *Id.*

214. *Id.*

215. European Commission, *A Study on Systems of Civil Liability of Statutory Auditors in the Context of a Single Market for Auditing Services in the European Union*, at 3.1.3 (Apr. 2003), available at ec.europa.eu/internal_market/auditing/docs/liability/auditliability_en.pdf.

216. Conrad Hewitt, Chief Accountant, SEC, Remarks at the Practising Law Institute’s SEC Speaks Series, (Feb. 9, 2007), available at <http://www.sec.gov/news/speech/2007/spch020907cwh.htm>.

217. EURACTIV, *supra* note 194; Directorate General for Internal Market and Services, *Commission Staff Working Paper: Consultation on Auditor’s Liability and its Impact on the European Capital Markets*, at 12 (Jan. 2007), available at http://ec.europa.eu/internal_market/auditing/docs/liability/consultation-paper_en.pdf [hereinafter Directorate General, *Commission Staff Working Paper*] (explaining that, while European nations have adopted a flat cap on auditor liability, there are various problems which make it an unlikely solution to the auditor liability problem).

218. Letter from Liz Murrall, Senior Advisor – Corporate Governance, Inv. Mgmt. Ass’n, to European Commission (Mar. 23, 2007), available at http://www.investmentuk.org/news/research/2004/topic/corporate_governance/062-07-01.pdf (regarding “EU consultation on [a]uditors’ [l]iability and its [i]mpact on the European [c]apital [m]arkets”).

219. *Id.* at 3 (quoting EC-DG Internal Mkt. & Svcs., *Final Report: Study on the Economic Impact of Auditor’s Liability Regimes*, at xxiii, MARKET/2005/24/F (Sept. 2006) (prepared by London Economics in association with Professor Ralph Ewert), available at http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf.

220. See generally Dornbrook, *supra* note 28.

221. Interview by U.S. Dep’t of Treasury, Advisory Comm. on the Auditing Profession with Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Pub. Employee’s Ret. Sys. (Apr. 30, 2008), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf>.

decrease in investor confidence, is the precise reason why the cap on auditor liability is not the proper solution.²²²

Providing auditors with a fixed monetary cap as a ceiling to liability will most certainly decrease the incentive to provide accurate and thorough reports to investors on the financial health of a corporation. This proposal goes directly against the SEC's goal of increasing transparency and will likely decrease investor confidence once they learn that auditors' liabilities are capped.²²³ Furthermore, the fact that there is a precise dollar amount for the cap could lead auditors to do a cost-benefit analysis to determine whether it is cost-effective to expend the labor and time necessary to perform the most accurate audit reports. In our current economic climate, we need continued investment from investors. Establishing a policy that will threaten the prospect of increased investment by reducing investor confidence is not befitting of our financial crisis.

The next proposal is a cap based on the size of the corporation being audited.²²⁴ The goals of this system are similar to that achieved by a fixed cap, but this method ensures proper compensation "since it considers the possible relevance of the audited company's size with reference to the amount of damages that can be assessed."²²⁵ This system will theoretically prevent the catastrophic loss that auditors could potentially face should they make a mistake that leads the audited corporation or its shareholders to sue.²²⁶

Caps based on the size of the corporation are not without their problems either.²²⁷ Criticisms largely stem from utilizing market capitalization as the proxy for determining liability.²²⁸ Different nations calculate market capitalization in a variety of ways, and there would be difficulties when dealing with listed as opposed to unlisted corporations.²²⁹ Furthermore, market capitalization is a highly volatile figure that can alter drastically from the time the audit is performed to when the potential lawsuit begins.²³⁰ Regardless, a cap based on the size of the corporation is still an overall ceiling to the liability that auditors will face, and brings with it the same problems of decreased quality and accuracy that any other flat cap does.²³¹

222. Irving et al., *supra* note 27, at 8.

223. See generally SEC, *supra* note 22 (as the goal of the SEC in creating statutory audits was to prevent fraud and misstatements and increase investor confidence by holding auditors liable, decreasing this liability is in direct opposition to the purported goals of the SEC).

224. See EURACTIV, *supra* note 194.

225. Directorate General, *Summary Report*, *supra* note 16, at 22.

226. See *id.*

227. See *id.* at 23.

228. See *id.*

229. See EURACTIV, *supra* note 194.

230. See Directorate General, *Summary Report*, *supra* note 16.

231. Murrall, *supra* note 218.

Auditors will be less careful if they know that they do not face unlimited liabilities. This plan may even be worse than a fixed monetary cap because auditors' potential liability to small corporations that are not highly capitalized will be relatively minimal. This means that auditors will have a disincentive to do thorough work in smaller corporations, regardless of whether or not they are listed, gravely affecting the capital markets as potential investors will be aware of these decreased incentives. This will not only deter investment in smaller corporations, but will also diminish confidence in the stock market in general as the major incentive for auditors to do thorough work would be limited.

The third proposal is a cap that is calculated by taking a multiple of the audit fees the auditor charged for the services in question.²³² This plan is purported to be a neutral basis from which to formulate a cap.²³³ This plan also avoids the potential disparate risks that would exist between listed and unlisted companies.²³⁴ A cap based on a multiple of the audit fee is a system of liability capping that is seen by many to be a reasonable proxy for proportionate liability because the audit fee is negotiated by reference to the size, complexity, and risk of the audit assessment.²³⁵

There are arguments against utilizing a multiple of the audit fees charged because this plan risks creating a fee dropping scenario whereby auditors will continuously decrease the cost of their auditing services and try to make up for the loss in non-audit services.²³⁶ This decrease in costs could also mean that the potential will exist for decreased quality, thereby rendering audit reports inadequate to promote investor confidence in the capital markets.²³⁷ Furthermore, when large corporations pay for audit services, they normally pay a large amount for the entire corporation that is often arbitrarily allocated to different individual group members, and therefore, may not be entirely proportional to the work that has been done or the liability that should exist.²³⁸

While multiplying the auditor's fees may arguably be more reasonable than a flat cap on liability, it is merely the lesser of two evils. Capping liability, regardless of the dollar amount that is used, still reduces the incentive to perform quality audits. Furthermore, since auditors are the ones calling for this cap, it is extremely likely that the industry as a whole will set artificially low prices to cap liability as low as possible. Auditors will focus on the non-audit aspects of their business, and the role of the external auditor, as the SEC has created it, could largely disappear. Liability will be

232. EURACTIV, *supra* note 194.

233. Ojo, *supra* note 199, at 6.

234. *Id.*; see also Zubli, *supra* note 130, at 2.

235. Directorate General, *Summary Report*, *supra* note 16, at 23.

236. *Id.* at 24.

237. *Id.* at 23–24.

238. *Id.*

so minimal that fear of litigation will no longer serve as an impetus to honestly report to potential investors.

The final plan calls for proportionate liability.²³⁹ The basic premise of proportionate liability is that the auditor is only liable for the portion of damage that corresponds to their degree of responsibility.²⁴⁰ Proportionate liability has recently gained scholarly attention, as it has been included in a plan adopted by the U.K.²⁴¹ Amendments have been made to the Companies Act in order to permit auditor liability limitation agreements.²⁴² The Companies Act requires approval of auditor liability limitation agreements by the shareholders and the agreement must be fair and reasonable in order to be upheld.²⁴³ This is the key component to the legislation because it gives courts the ability to override any element of the agreement that is neither fair nor reasonable, and set a new level of liability, regardless of who has approved the contract.²⁴⁴ While the determination of what is fair and reasonable is left to the courts, the Companies Act states abstract principles to guide courts in rendering their decision.²⁴⁵ In fact, the guiding principles are so abstract that they offer little to no actual guidance to the courts anyway.²⁴⁶

Proportionate liability is often favored by a majority of constituencies that support capping the liability of auditors.²⁴⁷ Yet, it is still defective. There are difficulties surrounding how the court will determine what the exact degree of responsibility was for particular individuals or groups.²⁴⁸ Furthermore, terms such as “fair and reasonable” or “proportionate to their responsibility,” which serve as the backbone of the limitation agreements,

239. *Id.* at 24–25.

240. Directorate General, *Commission Staff Working Paper*, *supra* note 217, at 13.

241. The Corporate Counsel, *supra* note 178.

242. Directorate General, *Summary Report*, *supra* note 16.

A liability limitation agreement is defined in the Act as an agreement that purports to limit the amount of a liability owed to a company by its auditor in respect of any negligence, default, breach of duty or breach of trust occurring in the course of the audit of accounts, for which the auditor may be responsible in relation to the company.

FINANCIAL REPORTING COUNSEL, GUIDANCE ON AUDITOR LIABILITY LIMITATION AGREEMENTS, 2008, § 2.2.

243. The Corporate Counsel, *supra* note 178.

244. Directorate General, *Summary Report*, *supra* note 16, at 25.

245. FINANCIAL REPORTING COUNCIL, *supra* note 242, §§ 2.4, 2.5. These abstract principles include: the auditor’s liability under the Act; the nature and purpose of the obligation the auditor has to the corporation; and the professional standards of auditors. *Id.*

246. *See id.* § 2.5.

247. Directorate General, *Summary Report*, *supra* note 16, at 24; *see also* FINANCIAL REPORTING COUNCIL, *supra* note 242, § 2.13 (discussing the overall uncertainty that surrounds the interpretation of these clauses).

248. Directorate General, *Summary Report*, *supra* note 16, at 24–25.

are not definitive legal standards.²⁴⁹ Even in the U.K., where proportionate liability has been adopted, regulators have made it clear that they will not define the parameters of the fair and reasonable standard.²⁵⁰ Rather, this determination will be made on a case-by-case basis, allowing the courts to substitute their own terms where they find that the contractual limit was insufficient.²⁵¹ Establishing proportionate liability through contractual clauses may not be feasible for all nations, especially those where auditors can be held liable in tort law.²⁵² Furthermore, depending on how high the degree of responsibility is, the liability the auditors face may still be incredibly high, failing to address the largest grievance of proponents of any plan to cap the liability of auditors.²⁵³

Theoretically, proportionate liability appears to be the most promising means of capping auditor liability, as auditors will only be held liable for their own misconduct. However, determining the liability of each party involved in corporate misconduct that could potentially have occurred over long periods of time, in various parts of the corporation, will be difficult, if not impossible. Allowing courts to determine what is fair and reasonable in an agreement to cap the liability of auditors permits judges to act as legislators in determining when and how the liability of auditors should be capped. This means that different courts throughout the country will establish varying standards for what is fair and reasonable. If auditors' liabilities are going to be capped, then it should be a result of a uniform decision by the legislature to provide a national solution.

While there are many proponents for capping auditor liability,²⁵⁴

[a]rtificially limiting auditor liability [will] diminish incentives to push back on overreaching management, reduce auditor accountability and reduce audit quality. This would, in turn, harm our capital markets, because it would undermine the most precious and fragile commodity we have—investor confidence in the accuracy and transparency of financial statements. To sum up the merits of a cap on auditor liability in two words: Not smart.²⁵⁵

249. Frances Brown et al., *United Kingdom: Limiting Auditors' Liability: The Sky is No Longer the Limit*, MONDAQ.COM, Apr. 16, 2008, available at <http://www.mondaq.com/article.asp?articleid=59340>.

250. *See id.*

251. *Id.*

252. Directorate General, *Summary Report*, *supra* note 16, at 25. Countries where auditors have dual liability in tort law would have issues because they may not wish to establish proportionate liability in torts, and defendants would have to be held to two different standards, which would largely defeat the goal of capping the liability of auditors in the first place. *Id.*

253. *Id.* at 24–25. The EU supports an exception for intentional misconduct, but this does not go far enough to remedy the aforementioned issues, as it is the effect of the flawed audit statement not the nature of the breach that is at issue. Commission Recommendation (EC) No. C (2008) 2274 of 5 June 2008, 2008 O.J. (L 162) 39.

254. Directorate General, *Summary Report*, *supra* note 16, at 24.

255. Coffey, *supra* note 10, at 2.

Because individual investors are vital to our capital markets, we must be sensitive to their needs and consider what policies are best suited to protect their interests and confidence in the market.²⁵⁶

CONCLUSION

In considering the potential effects of capping the liability of auditors it is necessary to keep in mind what the role and the purpose of the external auditor is in our international capital markets.²⁵⁷ The significance of the audit is due to the fact that it provides

an important part of the capital market framework[,] as it not only reduces the cost of information exchange between managers and shareholders but also provides a signalling mechanism to the markets that the information which management is providing is reliable. The auditor provides *independent* verification o[f] the financial statements of a company and as a result, the audit loses its value when such independence which gives credibility to the financial statements, is undermined.²⁵⁸

Statutory auditors are an integral aspect of establishing investor confidence in our capital markets.²⁵⁹ In light of the current domestic financial crisis, and the effects that the U.S. capital markets have on the global capital markets as a whole,²⁶⁰ investor confidence is incredibly important to promote investment in the U.S. capital markets.²⁶¹ In a recession, investor confidence is arguably one of the most important aspects to promote increased investment, thereby increasing demand and decreasing layoffs.²⁶² The success of a capitalist system is based on growth and investment. Establishing sufficient investor confidence ensures this.²⁶³

Auditors argue that they face potentially devastating liabilities. However, if their work is properly performed, these liabilities cease to exist. Decreasing liability decreases the incentive to do thorough and accurate work, as the potential costs of a mistake are lessened when liability is decreased. Auditor liability was created by the SEC to increase accuracy and investor confidence. Decreasing auditor liability will go great lengths in

256. Stout, *supra* note 3, at 36.

257. SEC, *supra* note 22.

258. Ojo, *supra* note 9, at 2 (emphasis in original).

259. Irving et al., *supra* note 27, at 8.

260. See Posting of Bob McTeer to Economix, *available at* <http://economix.blogs.nytimes.com/2008/11/19/which-part-of-the-economy-will-carry-us-through-this-recession/> (Nov. 19, 2008, 09:21 EST).

261. Mark W. Olson, Chairman, Pub. Co. Accounting Oversight Bd., Speech at FEE Conference on Audit Regulation: Auditor Oversight and Its Implications on the Resilience of Our Capital Markets (Oct. 12, 2006), *available at* http://pcaobus.org/News/Speech/Pages/10122006_OlsonFEEConferenceAuditRegulation.aspx.

262. DAVID SCHWEICKART, *AGAINST CAPITALISM* 162 (1996).

263. *See id.*

shattering the confidence of investors. “Investor [confidence] provides the foundation on which the American securities market has been built. Without such trust, our market would be a thin shadow of its present self.”²⁶⁴ It is evident that to cap liability at a time when investor confidence is needed most is both inappropriate and irresponsible financial legislation, and the U.S. capital markets cannot afford the loss of investment that will accompany a cap in this financial crisis.

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264. Stout, *supra* note 3, at 3.

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