PRELIMINARY AND INCOMPLETE DRAFT

PLEASE DO NOT CITE WITHOUT AUTHOR'S PERMISSION

WHY AUDITORS?
AUDITORS' ROLES AND THEIR MULTI-LAYERED LIABILITY REGIME

PAOLO GIUDICI*

In this paper it is argued, through a comparison among three different legal regimes (US, UK, Italy) and the analysis of some recent paradigmatic cases (in particular *Stone & Rolls* and *Parmalat*), that the approach towards auditor liability currently dominating the global scientific discussion and which is reflected in the EC Commission's recommendation of 5 June 2008 is flawed. The idea that auditor liability has to be generally limited over-simplifies a complex issue, because it assumes that the auditor has one role and faces one liability regime, whereas it (the auditor) potentially has three or four roles and subsequently many potential liability regimes. Accordingly, the concept of auditor multi-layered liability is introduced and its problems and implications are analyzed. In doing so, it is specifically pointed out that the quantitative economic research in this field cannot be used to assess *a priori* what is the most efficient liability regime. As to qualitative economic research, it has greatly enriched the debate, although the "wealth transfer argument" offered to argue that auditors should not be liable towards secondary market investors has been over-extended. In spite of the fact that there is no single, ideal multi-layered liability regime, as the elements to be considered range from issues relating to corporate governance, bankruptcy and financial markets, civil procedure, which are therefore very country-specific, favor both for contractual limitation to auditor liabilities and for the abolition of mandatory audits is expressed. With reference to the three legal systems examined, it is shown that the UK scenario is not a coherent one and, especially after *Stone & Rolls*, can no longer be regarded as a model. Italian substantial rules have some merits, even though there is an overreach of auditor liability towards secondary market investors in an attempt to counterbalance Italy's lax private enforcement system. The general framework of the US system is skewed to protect auditors, and many provisions concerning liability towards secondary market investors do not find any strong theoretical justification but are embedded in the peculiarities of the US private enforcement system, and must be read as such by the vast economic literature that covers this article's main topics.

Table of Contents

Introduction 3
I. The economic literature on audit litigation 7
A. Introduction 7
B. Qualitative studies 8
C. Quantitative studies 9
1. Looking for Predictors 9

2. Do the Merits Matter? ... 10
3. Post-PSLRA research ... 10
D. Corporate Governance Indices ... 11
E. Assessment ... 12
II. Auditors' liability to the company (regime 1) ... 13
A. The Auditor as the Shareholders' Watchdog (England) ... 14
B. The US experience ... 15
1. The 'Imbroglio' ... 15
2. Doctrines ... 16
3. Two rationales for the imputation defense and their critique ... 17
4. The Stone & Rolls Case ... 19
5. The Decision ... 19
6. Some General Comments about Stone & Rolls ... 20
C. Italy ... 21
1. The Framework ... 21
2. Why There Is No Trace of the Imputation Defense in Italy? Four Reasons ... 21
3. Parmalat's US Adventure ... 22
D. Contractually negotiated caps to liability ... 23
1. The Issue ... 23
2. Analysis: Shareholders' Collective Action Problem ... 23
3. The Intergenerational Problem ... 24
III. Auditors and liability to third parties under general private law doctrines (regime 2) 24
A. Ultramares Legacy ... 24
1. Judge Cardozo's Decision ... 24
2. The Floodgate Argument ... 25
3. Where the Floodgate Argument Does Not Bite: Italy ... 26
B. The Floodgate Argument Problem: The Treatment of the Insolvent Company's Creditors 27
1. The Stone & Rolls Quagmire ... 27
2. The "Wrongfully-Incurred Unpayable Debt" Quagmire ... 28
3. Italy's Specificity ... 28
IV. Auditors and investors in primary capital markets (regime 3) ... 30
A. In IPOs, Auditors are Reputational Intermediaries Needed by the Issuer ... 30
B. Prospectus Auditing and Why the Floodgate Argument Is No Longer an Issue 31
1. US and UK ... 31
2. Italy ... 31

3. Why Were Voluntary Liability Caps Not the Norm? Incomplete Audit Contract as an Efficient Strategy both for the Issuer and the Auditor ... 31
V. Auditor's liability in secondary markets (regime 4) ... 33
1. UK ... 33
2. US ... 33
3. Italy ... 34
B. Law & Economics Analysis ... 34
1. In Favor of No Liability Whatsoever (Except Intentional Misrepresentation): the Pure "Wealth Transfer" Argument ... 34
2. In Favor of Liability ... 35
3. What Kind of Liability? ... 36
4. Proportionate versus Joint and Several Liability ... 37
5. Limiting Liability through Company Law ... 37
VI. Problems created by the overlap ... 38
A. Double Recovery (Overlap of Regimes 1 and Regimes 3 or 4) ... 38
1. CENCO ... 38
2. Analysis ... 39
B. Regimes 3 and 4 Overlap Problems ... 40
1. Tracing ... 40
2. Liability Cap Problems ... 40
VII. Conclusion ... 40

INTRODUCTION

The accounting scandals of 2001-2003 raised serious questions about the role of auditors as the main gatekeepers of modern financial markets.[1] The idea that auditing firms had all the incentives to efficiently monitor their client and denounce wrongdoings collapsed.[2] In the ensuing debate, many scholars claimed that deterrence in the form of civil liability had been reduced and had thereby been unable to prevent auditors from relaxing their expected professionalism and care.[3] However, the dissolution of Arthur Andersen which followed Enron's bankruptcy had in the meantime introduced a new ingredient to the otherwise traditional topic of auditor's liability.[4] The audit market was becoming increasingly

* Professor of Business Law, Free University of Bozen-Bolzano, Italy. Research Associate, ECGI. Director, Center for Research in Law & Economics (CRELE), Bozen-Bolzano.

[1] JOHN C. COFFEE JR., Gatekeepers: The Professions and Corporate Governance (Oxford Univ. Press. 2006)., 103 ff.

[2] *See infra* ___

[3] JOHN C. COFFEE JR., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 Bus. Law. 1403, 1409-12 (2002).

[4] Cf. ROY CHANDLER & JOHN RICHARD EDWARDS, *Recurring Issues in Auditing: Back to the Future?*, 9 Accounting, Auditing & Accountability Journal 4, 20 (1996).

concentrated with the 'Big Four' (Deloitte & Touche, Price Waterhouse Coopers, Ernst&Young, KPMG) auditing the majority of listed companies worldwide. Hence two new problems were surfacing. First, legal liability might put in danger one of the remaining networks.[5] Second, if the Big Four understand that they are "too big to fail", moral hazard arises.[6]

Crisis usually introduces re-regulation, and the 'Big Four' started a new intense worldwide lobbying campaign demanding protection from legal liability,[7] on the premise that a catastrophic judgment against one of them could have put a final end to the whole industry.[8] In the US, auditing firms also started to ask for arbitration clauses, indemnity and hold-harmless provisions, and damages exclusions in their engagement contracts with American issuers.[9] Auditors' calls did not go unheard. In the US, the discussion concerning securities class-actions was re-opened. The core issue was that these powerful weapons could be fired at auditors, the traditional "deep-pocket" of financial scandals ending up in catastrophic insolvencies, all too easily.[10] In the UK, auditors obtained a statutory right to limit their liability contractually under ss. 534-536 of the 2006 Companies Act. At European Union

[5] For an attempt to analyze viability threats to Big Four auditing firms in relation to securities fraud class actions ERIC L. TALLEY, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 Colum. L. Rev. 1641, 1673-93 (2006).

[6] LAWRENCE A. CUNNINGHAM, *Too Big To Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels*, see id. at 1698, 1698-99.

[7] The previous campaign had led to the passage of the Private Securities Litigation Reform Act ("PSLRA"): *see infra* test accompanying note ___

[8] This risk is considered by TALLEY.

[9] Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, 71 Fed. Reg. 6847, 6847 (Feb. 9, 2006). The SEC contests indemnity provisions, holding that they impair independence: Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence, Frequently Asked Questions (http://www.sec.gov/info/accountants/ocafaqaudind121304.htm):

Question 4 (issued December 13, 2004). "Q: Has there been any change in the Commission's long standing view (Financial Reporting Policies – Section 600 – 602.02.f.i. "Indemnification by Client") that when an accountant enters into an indemnity agreement with the registrant, his or her independence would come into question?

A: No. When an accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity which seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, the accountant is not independent. Further, including in engagement letters a clause that a registrant would release, indemnify or hold harmless from any liability and costs resulting from knowing misrepresentations by management would also impair the firm's independence."

[10] See Comm'n on the Regulation of U.S. Capital Mkts. in the 21st Century, Report and Recommendations 28–31 (2007), available at http://www.uschamber.com/publications/reports/0703capmarketscomm.htm ("International observers increasingly cite the U.S. legal and regulatory environment as a critical factor discouraging companies and other market participants from accessing U.S. markets."); NYCEDC, 74–75 (arguing that, despite decrease in securities litigation filings in 2005–2006, fear of litigation puts New York City at a disadvantage vis-a-vis London); Luigi Zingales et al., Interim Report of the Committee on Capital Markets Regulation, at x–xi (2006), available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf [hereinafter Zingales et al., Interim Report] (citing liability risk as factor contributing to decrease in U.S. public equity market competitiveness); see also Comm. on Capital Mkts. Regulation, The Competitive Position of the U.S. Public Equity Market 1–5 (2007), available at http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf (providing additional data demonstrating loss of public equity market competitiveness). Cf. also JOHN C. COFFEE JR., *Reforming the Securities Class Action: An Essay On Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534(2006).(proposing different means to reform securities class actions avoiding their circularity problem and increasing their deterrent value); AMANDA M. ROSE, *Reforming Securities Litigation Reform: Restructuring The Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 Colum. L. Rev. 1301(2008).(proposing to grant the SEC the authority to screen, and approve or reject, Rule 10b-5 class action complaints before filing)

level, the Commission recommended Member States to adopt liability caps in order to protect auditors,[11] following the results of a study ("Final Report") on the issue that it had commissioned.[12] The recommended limitation of liability for auditors would put the industry in a situation very similar to the other few industries that enjoy limited exposure to civil liability, like the shipping,[13] the airline,[14] and the nuclear industries.[15] Thus, the Commission's recommendation represents a great success for auditors, who have lobbied legislators for decades in order to get protection, and a turning point in the regulation of the audit industry.

In the meantime, the "subprime" financial crisis exploded, momentarily shifting attention away from auditors.[16] However, the debate that has been raging since this new crisis has thrown new light on the issue of auditor liability. Amongst the new culprits there are rating agencies, which have so far escaped civil liability.[17] Many proposals suggest a re-regulation of rating agencies that is based at long last on their exposition to civil sanctions.[18] Thus, paradoxical as it may appear, the Enron-era of financial scandals has lead to recommendations for a reduction in auditors' liability so as to protect the 4-incumbents dominated audit industry, whereas the Subprime Crisis is opening a discussion about increasing the exposure to civil liability of the 3-incumbents dominated credit rating industry.[19] These are times of great confusion.

---

[11] Commission Recommendation, 5 June 2008, doc. No. C(2008)2274. This recommendation is a result of the 8th Company Law Directive (17 May 2006 Directive of the European Parliament and the European Council on the statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EC and 83/349/EEC), which reshaped statutory audit regulation in the light of the recent failure but at the same time asked the European Commission to report "on the impact of the current liability rules for carrying out statutory audits on the European capital markets and on the insurance conditions for statutory auditors and audit firms, including an objective analysis of the limitations of financial" (Article 31 Directive 2006/43). The Commission asked for a study on the issue, which suggested introducing liability caps to auditor liability towards investors:

[12] Study on the Economic Impact of Auditors' Liability Regimes (MARKT/2005/24/F): Final Report To EC-DG Internal Market and Services. pt. 1-332 (2006).

[13]

[14]

[15]

[16] With the exception of the Madoff and Stanford affairs.

[17] With arguments that recall many issues of the auditor liability's debate: "But at the same time that CRAs want to fend off more detailed regulation of their activities by emphasizing that their work is sound, they also want to fend off liability by presenting their work as a matter of opinion. While CRAs publicly state that their ratings are "information," on which they encourage investors to rely, in their interactions with regulators CRAs tend to argue that ratings are opinions rather than facts": CAROLINE M. BRADLEY, *Rhetoric and the Regulation of the Global Financial Markets in a Time of Crisis: The Regulation of Credit Ratings,* Transnational Law & Contemporary Problems, Forthcoming (2009).

[18] Cf. FRANK PARTNOY, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 Wash. U.L.Q. 619(1999).rating agencies should not simultaneously benefit from ratings-dependent regulation and be insulated from lawsuits alleging negligence or misrepresentation; FRANK PARTNOY, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, Council of Institutional Investors, April 2009, 14-16 (2009). JOHN P. HUNT, *Credit Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, SSRN eLibrary (2008).proposing that rating agencies either disclose the poor quality of the financial products they rate or disgorge profits derived from rating the products.

[19] Curious reverse analogies do not stop here. The criticism of governments and regulators that left banks became "too big to fail" has mounted in the wake of the subprime collapse. Observers point out that much of the size and complexity of many banks is designed to render their operations opaque to regulators, tax authorities and even shareholders (see Willem Buiter, *How not to reform financial markets*, FT maverecon page, July 9, 2009 7:35pm). The suggestion is to reduce bank size and complexity (Patrick Jenkins and Brooke Masters, *FSA's Turner backs living wills for banks*, Financial Times, September 2 2009). However, the parallel discussion concerning auditors never went in the direction of reducing the size or complexity of the companies

The discussion concerning auditor liability has gone global and this has contributed to generate confusion. The auditor liability issue has been too easily covered as a transnational topic that can be addressed in a generic, unified way, usually by drawing from the US experience. There are many worrying indicia of the existing level of confusion. Probably the most significant one is offered precisely by the EC Commission's recommendation. The international scientific debate mainly concerns the exclusion or limitation of auditor liability towards secondary market investors. Nowhere is statutory limitation of auditor liability to the company subject to much discussion. However, the Commission ended up recommending that the limitation of liability should also apply against the company audited. Apparently the Commission took the economic arguments in favor of limiting the auditor liability toward third parties and extended them to a very different issue, namely liability to the client company. But as I will point out, this sort of confusion is widespread in the literature, especially the economic one. Indeed, the topic of auditor liability is too frequently treated as if there is one major regime to be approached and discussed, instead of four potential regimes: liability to the company (which I will call "regime 1"); liability to the creditors ("regime 2"); liability to primary market investors, namely prospectus liability ("regime 3"); liability to secondary market investors ("regime 4").

In times of confusion it is helpful to stand back and "try to identify the essentials."[20] What is the auditor's role? Has the auditor one principal or many? If the answer is that the auditor has many principals, how should a multi-layered liability regime be designed? Is there room for freedom of contract in a multi-layered liability regime, or should the law impose mandatory, interlocked regimes? These are some of the research issues that this article will try to deal with. In order to sort them out, I start from the premise that, from a social welfare perspective, auditing is a tool to reduce the cost of firms' capital. Civil liability should induce auditors to invest in cost-effective measures designed, in general terms, to monitor managers and reduce the risk of misstatements in financial reports, thereby enabling auditors to offer, and charge for, the quality of care that shareholders, creditors, investors (as the case may be) are willing to pay for. When market failures are absent, the liability regime should be left in the hands of the concerned parties, since they have all the incentives needed to design their relationship and choose the contractual sanctions to which expose themselves. When market failures can be identified and civil liability is kept as a regulatory tool,[21] liability is mandated (statutory liability), and it is on the law to efficiently design the civil liability regime. Accordingly, any discussion about auditor liability must investigate who are the concerned parties, whether the concerned parties are in a position to negotiate in order to design the optimal liability regime, whether and at which stage market failures prevent contractual negotiation, what kind of positive (or negative) interferences stems from multiple negotiations and a multi-layered liability regime, and how should this multi-layered regime be organized.

The best way to cope with these complex problems is to face them sequentially, considering different legal systems in order to illuminate, through a cross-sectional analysis, the key issues at play in the auditor liability's debate. In this article I analyze auditor liability issues in three very different regimes (US, UK, Italy). I have collected more than two hundred court decisions (see annex A), which I have classified and catalogued in order to understand more precisely how each of these three legal systems treat the research issues. The choice of these three regimes (I consider the US as one country, even though states'

audited, both features of which presumably create an entry barrier to new audit firms wanting to vie with the Big-4, and – more importantly – actually focuses precisely on how to protect firms that are now "too big to fail."

[20] I am borrowing this phrase from HL,Stone & Rolls, § 186.

[21] Public regulation is another instrument to cope with market failures. Usually the legal system uses both private enforcers (through civil liability) and public ones (though regulation) to cope with market failures.

legislations can be very different) is easily explained. The US are the reference point for all the economic and law and economics literature. Moreover, the US offer a rich variety of cases and problems, and US federal securities regulation is the dominant model in the world. UK is a reference point as well, at least for the European countries. It offers the appearance of a very straightforward legal environment, radically different from the US one. Moreover, as it will be noted, it is experimenting contractually negotiated liability of the auditor to the company. As to Italy, according to the Final Report it is the legal environment where the audit industry is subject to the most intolerable litigation risk.[22] For sure it offers a legal environment that is completely different, also with regards to substantive rules, to the US one and, even more significantly, to the UK.

Through my analysis I argue that the approach towards auditor liability reflected in the EC Commission's recommendation is flawed. I propose a prudent approach, with some policy suggestions that go in the direction of liberalizing audit instead of imposing mandatory solutions. These mandatory solutions seem to be exclusively driven by the "too big to fail" argument and the desire to protect a very rich oligopolistic industry. This industry was invented by private ordering and now, at any accounting crisis, find ways to encroach itself always more deeply into the foundation of regulation. In short, I think that it is time to go in a direction completely different from the one followed by the US and EU.

The article proceeds as follows. Section I reviews audit litigation research and how the law and finance literature covers auditor liability issues. Section II analyzes auditor liability to the company and compares the three legal systems I have mentioned. I also consider caps to liability negotiated by the client company and the auditor. Section III considers auditor liability to third parties under general private law doctrines and analyzes the floodgate argument, deemed a key concept in the law and economics literature concerning pure economic loss. Section IV considers prospectus audit liability and negotiated caps to auditor liability in this specific area. Section V deals with auditor liability to secondary market investors, discusses and offers a critique of the "wealth transfer" argument and considers the link between primary and secondary markets. Section VI presents the problems that a multi-layered liability environment poses, among which double recovery and liability caps are probably the most significant. Section VII concludes.

I. THE ECONOMIC LITERATURE ON AUDIT LITIGATION

A. *Introduction*

There is a vast economic literature on audit litigation, proposing either adjustments to auditor liability regimes or evaluating the impact of amendments to these regimes. The interest for the subject started in the first half of the 1970s in the US,[23] as a result of some large American accounting scandals in the previous decade that generated a litigation explosion,[24] often described in catastrophic terms.[25] This explosion was also caused by the amendment to Rule 23 of the Federal Rules of Civil Procedure (FRCP), which opened up the

---

[22] Final Report, supra note __, at 161.

[23] DOUGLAS W. HAWES, *Stockholder Appointment of Independent Auditors: A Proposal*, 74 Colum. L. Rev. 1, 2 (1974).

[24] T.J. FIFLIS, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 Vand. L. Rev. 31, 33 (1975).

[25] NEWTON N. MINOW, *Accountants' Liability and the Litigation Explosion*, Journal of Accountancy 70(1984).

road to modern securities class actions.[26] Two streams of literature arose in the wake of this litigation explosion: one qualitative, the other quantitative.

B. Qualitative studies

Qualitative studies model *a priori* efficient liability regimes. The academic interest is mainly focused on liability towards third parties. Probably the most influential study in the law literature is Professor Goldberg's, who firstly asserts that auditor tort liability to third parties is unnecessary, because third parties can purchase assurance from the auditor if they want to (through the company, which acts as an intermediary between the auditor and the market)[27] and, secondly, points out that reputation protection is a strong incentive for the auditor to take adequate care.[28] The accounting crisis of 2001-2003 showed that reputation alone is not sufficient.[29] Despite this crisis, many studies still argue that the effect of reputation on audit quality should at least be taken into account when modeling the auditor liability regime.[30] This argument could raise suspicions, as it should be applied to any defendant in a tort claim, not only to auditors. However, as I will show, liability towards secondary market investors might be sufficiently specific to make the argument partly convincing in that restricted field.[31]

Other qualitative studies model the interplay between audit standards and auditor liability[32] or auditor wealth.[33] Many compare different liability rules[34] or joint and several

---

[26] PAUL G. MAHONEY, *The Development of Securities Law in the United States*, 47 J. Acc. Research 325, 333-339 (2009).

[27] VICTOR P. GOLDBERG, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. Legal Stud. 295, 301-7 (1988).

[28] Id. at 302-4. For more mathematically framed models see V. G. NARAYANAN, *An Analysis of Auditor Liability Rules*, 32 Journal of Accounting Research (1994).(asserting that proportionate liability is better than joint and several liability with reference to 10b-5 class actions); FRANK GIGLER, *An Analysis of Auditor Liability Rules: Discussion*, 32 Journal of Accounting Research (1994).

[29] The role of reputation was grounded on the assumption that market incentives were strong enough to prevent auditors' lack of care or cooperation in fraud, since auditors share none of the gains of fraud or just a small fraction of them and are exposed to a large fraction of the risk in the form of reputation disruption. Judge Easterbrook famously exposed this position in *DiLeo v. Ernst & Young*, 901 F.2d 621, at 629. This assumption ignored the existence of agency problems within the audit firm, which incentivised partners to put in danger the firm's reputation in order to pursue their own monetary incentives: see JOHN C. COFFEE JR., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 Cornell L. Rev. 269, 301-2 (2004). Moreover, the assumption ignored the fact that shareholders and investors cannot observe the audit quality, and that litigation is an incentive to investigate the audit process. For findings that audit quality is linked to litigation risk more than to pure reputation constraints see, in the accounting literature, INDER K. KHURANA & K K. RAMAN, *Litigation Risk and the Financial Reporting Credibility of Big 4 Versus Non-Big 4 Audits: Evidence from Anglo-American Countries*, 79 Acct. Rev. 473(2004). CLIVE S. LENNOX, *Audit quality and auditor size: An evaluation of reputation and deep pockets hypotheses*, 26 Journal of Business Finance and Accounting 779(1999). RAMGOPAL VENKATARAMAN & JOSEPH P. WEBER, *Litigation Risk, Audit Quality, and Audit Fees: Evidence from Initial Public Offerings* 83 Accounting Review 1315(2008). HO-YOUNG LEE, et al., *The Effect of the Private Securities Litigation Reform Act of 1995 on the Cost of Equity Capital* 48 Quarterly Journal of Finance and Accounting 85(2009).

[30] *See* JOCHEN BIGUS, *Auditors' Liability with Overcompensation and Reputation Losses*, ??? ??? (2009).

[31] *See infra* ___

[32] Compare RONALD A. DYE, *Auditing Standards, Legal Liability, and Auditor Wealth*, 101 J. Pol. Econ. 887(1993).(examining the interplay among auditing standards, liability rules, and auditors' wealths); RACHEL SCHWARTZ, *Auditors' Liability, Vague Due Care, and Auditing Standards*, 11 Review of Quantitative Finance and Accounting 183(1998). RALF EWERT, *Auditor Liability and the Precision of Auditing Standards*, 155 J. Inst. & Th. Econ. 181(1999).

[33] RONALD A. DYE, *Incorporation and the Audit Market*, 19 Journal of Accounting and Economics 75(1995).(analyzing AICPA 1992 decision to allow auditors to form general corporations and thereby shelter partners' wealth as an answer to the perceived 'crisis' in auditor liability).

liability regimes to proportionate liability regimes.[35] These studies are focused on tort liability to secondary market investors. Liability to the company is not covered, as the relationship between the company and the auditor is probably deemed to be a mainstream contract liability scenario that apparently does not offer sufficiently specific research issues. Liability to creditors is not an issue either, probably because in the US legal scenario the auditor is generally not liable to banks and trade creditors.[36]

C. Quantitative studies

The second stream concerns quantitative studies seeking to understand whether the US litigation crisis was really pending, and under what terms. These quantitative studies increased exponentially with the flood of litigation that followed the Savings & Loan debacle in the late 1980s, where auditors were accused of having contributed to the crisis with their lax approach.[37]

1. Looking for Predictors

A large part of these studies analyzed predictors of audit litigation.[38] Amongst the investigated predictors, there are the client company's asset structure and characteristics,[39] the client's probability of bankruptcy,[40] auditor independence,[41] the audit client's probability of becoming the target of an acquisition,[42] auditor characteristics,[43] auditor resignation,[44] previous Accounting and Auditing Enforcement Release (AAER) by the Securities and

---

[34] HANS-BERND SCHÄFER, *Efficient Third Party Liability of Auditors in Tort Law and in Contract Law*, Supr. Ct. Econ. Rev. 181(2004).

[35] An issue that the Big 6 audit firms had raised in 1992 and that lead to the PSLRA's amendment in 1995. *See infra* note ___

[36] *See infra*, ___

[37] For a general overview see JAN S. BLAISING, *Note, Are the Accountants Accountable? Auditor Liability in the Savings and Loan Crisis*, 25 Ind. L. Rev. 475(1991). ROBERT TILLMAN & HENRY N. PONTELL, *Organizations and Fraud in the Savings and Loan Industry*, 73 Social Forces (1994);CALAVITA, et al., *The Savings and Loan Debacle, Financial Crime, and the State*, 23 Annual Review of Sociology 19(1997). GEORGE A. AKERLOF & PAUL M. ROMER, *Looting: The Economic Underworld of Bankruptcy for Profit*, 2 Brookings Papers on Economic Activity 1, 23-36 (1993). For a thoughtful analysis of the Lincoln Savings and Loan's scam see MERLE ERICKSON, et al., *Why Do Audits Fail? Evidence from Lincoln Savings and Loan*, Journal of Accounting Research 165(2000).

[38] For a review, see CLAIRE KAMM LATHAM & MARK LINVILLE, *A Review of the Literature in Audit Litigation*, 17 J. Acct. Literature 175(1998).

[39] Cf. JAMIE PRATT & JAMES D. STICE, *The Effects of Client Characteristics on Auditor Litigation Risk Judgments, Required Audit Evidence, and Recommended Audit Fees*, 69 Accounting Review (1994). KENT ST PIERRE & JAMES A. ANDERSON, *An Analysis of the Factors Associated with Lawsuits Against Public Accountants*, 59 Accounting Review (1984).

[40] ZOE-VONNA PALMROSE, *Litigation and Independent Auditors: The Role of Business Failures and Management Fraud.*, 87 Auditing: A Journal of Practice and Theory 909(1987). This study showed that the allegation that the largest portion of failed companies were involved in audit litigation was false, that the most frequent resolution for business failures without management fraud was dismissal of the action against the auditor, the these dismissals were less reported in the financial press than damage payments made by the auditor to the plaintiff, and that the primary type of cases with large auditor payments were management fraud cases (101-102). Cf. also THOMAS LYS & ROSS L. WATTS, *Lawsuits against Auditors*, 32 Journal of Accounting Research (1994).

[41] LYS & WATTS.

[42] Id. at

[43] ZOE-VONNA PALMROSE, *An Analysis of Auditor Litigation and Audit Service Quality*, 63 Accounting Review (1988).

[44] JAGAN KRISHNAN & JAYANTHI KRISHNAN, *Litigation Risk and Auditor Resignations*, 72 see id. at (1997).

Exchange Commission (SEC),[45] the role of modified audit opinion.[46] It must be noted that this raft of studies refers to the US experience and generally aggregates all kind of lawsuits against auditors, without distinguishing the different legal scenarios.

2. Do the Merits Matter?

Predictors are clearly not enough to assert that an audit litigation crisis is pending. In order to assess the issue, it must be understood whether the merits matter in audit litigation, or whether auditors are drawn into unwarranted litigation aimed at coercing settlements. In particular Professor Zoe-Vonna Palmrose, following Professor Alexander's path-breaking research,[47] has devoted a significant part of her research agenda to the issue, analyzing empirical evidence concerning trials of legal disputes involving independent auditors[48] and reviewing the empirical results reached by the literature, to show that the merits might not matter.[49]

3. Post-PSLRA research

Because of lobbying pressure exerted by auditing firms, the Private Securities Litigation Reform Act (PSLRA) modified the litigation scenario, thereby protecting the auditors from securities class litigation.[50] Many of the studies at the end of the 1990s analyzed the new landscape, predicting that audit quality would be unaffected because reputation is key the driver of audit quality.[51] Other studies, however, took a different view, showing that exposure to liability (the deep-pocket hypothesis) prevails over reputation as an

---

[45] ROSS D. FUERMAN, *Naming Auditor Defendants in Securities Class Actions*, 7 Journal of Legal Economics (1997). The other four variables are the issuance of an AAER charging management; the audited company bankruptcy within a year from the start of the litigation; plaintiff class period length; a culpable restatement of previously issued audited annual financial statements.

[46] JOSEPH V. CARCELLO & ZOE-VONNA PALMROSE, *Auditor litigation and modified reporting on Bankrupt clients*, 32 J. Accounting Res. 1(1994).

[47] JANET COOPER ALEXANDER, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 1487(1991). Compare JOEL SELIGMAN, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority"* 108 Harv. L. Rev. 438(1994).

[48] ZOE-VONNA PALMROSE, *Trials of Legal Disputes Involving Independent Auditors: Some Empirical Evidence*, 29 Journal of Accounting Research (1991);MICHAEL L. ETTREDGE, *Trials of Legal Disputes Involving Independent Auditors: Some Empirical Evidence: Discussion*, 29 Journal of Accounting Research (1991).

[49] ZOE-VONNA PALMROSE, *Audit Litigation Research: Do the Merits Matter? An Assessment and Directions for Future Research*, 16 Journal of Accounting and Public Policy 355(1997).

[50] In 1991, in reaction to the litigation explosion that followed the Savings & Loan debacle, the (at the time) Big 6 and the American Institute of Certified Pubblic Accountants ("AICPA") started their effort to reform securities class actions. This effort initially influenced courts' approach towards auditor liability, leading the Supreme Court to its seminal decision Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 188-189 (1994), where the Court considered the arguments raised by the auditors' industry: DAVID L. GILBERTSON & STEVEN D. AVILA, *The Plaintiffs' Decision to Sue Auditors in Securities Litigation: Private Enforcement or Opportunism?*, 24 Iowa J. Corp. L. 681, 683 (1999). Following, the PSLRA was enacted, on the grounds of the intense lobbying activity of the audit industry: GILBERTSON & AVILA, 682 nt. 6 (passage of the Private Securities Litigation Reform Act of 1995 was based on testimony similar to the accounting firms' Statement of Position). See JOEL SELIGMAN, *Rethinking Private Securities Regulation*, 73 U. Cin. L. Rev. 95(2004);JAMES D. COX, *Making Securities Class Actions Virtuous*, 39 Ariz. L. Rev. 497, 515-23 (1997). Some studies assert that the reform significantly benefitted largest audit firms more than smallest ones: MARSHALL A. GEIGERA, et al., *Auditor decision-making in different litigation environments: The Private Securities Litigation Reform Act, audit reports and audit firm size* Journal of Accounting and Public Policy 332(2006).

[51] SRIKANT DATAR & MICHAEL ALLES, *The Formation and Role of Reputation and Litigation in the Auditor-Manager Relationship*, 14 Journal of Accounting, Auditing and Finance (1999). STEPHEN A. HILLEGEIST, *Financial Reporting and Auditing under Alternative Damage Apportionment Rules*, 74 Accounting Review (1999). But *see supra* note ___.

incentive to take care.[52] A stream of empirical studies, both in economic and legal literature, has started to measure the impact of the PSLRA on stock prices,[53] the cost of equity,[54] nonnuisance claims.[55]

The 2001 accounting crisis started with the restatement season, which researchers immediately investigated.[56] After the crisis, the wind changed direction, and subsequent studies started to assume more openly than in the past that litigation exposure increases perceived audit quality.[57] As mentioned, prominent legal scholars stressed that the crisis had been caused by gatekeepers' reduced exposure to liability.[58]

D. Corporate Governance Indices

Both academics and investors' advisors have developed metrics for measuring the corporate governance quality of whole legal systems or single firms.

The Law & Finance literature does not spend too much attention on auditor liability rules. They are mentioned for the first time in a 2006 much-quoted article concerning securities markets,[59] but exclusively with reference to prospectus liability.[60] Following articles do not expand the view.[61] Those results are puzzling, for at least four reasons. First, because the large majority of the accounting literature deals with secondary market liability, more than with IPO's settings.[62] Second, because the hypothesis of auditors' excessive

---

[52] LENNOX. LENNOX;HO-YOUNG; LEE, et al., *The Effect of the Private Securities Litigation Reform Act of 1995 on the Cost of Equity Capital*, 48 Quarterly Journal of Finance and Accounting 85(2009).

[53] Compare D. KATHERINE SPIESS & PAULA A. TKAC, *The Private Securities Litigation Reform Act of 1995: The Stock Market Casts Its Vote*, 18 Managerial and Decision Economics (1997). (indicating that the market believed that PSLRA's potentially positive consequences outweighed its potentially negative consequences); MARILYN F. JOHNSON, et al., *Shareholder Wealth Effects of the Private Securities Litigation Reform Act of 1995*, 5 Review of Accounting Studies (2000). (shareholders generally benefit from, although these benefits are mitigated when other mechanisms for curbing fraudulent activity are inadequate); ASHIQ ALI & SANJAY KALLAPUR, *Securities Price Consequences of the Private Securities Litigation Reform Act of 1995 and Related Events*, 76 Acct. Rev. 431(2001). (additional analysis conducted beyond the ones followed in the previously mentioned research are inconsistent with their conclusions and suggest that shareholders in four-high litigation-risk industries reacted negatively to the PSLRA).

[54] LEE, et al., *The Effect of the Private Securities Litigation Reform Act of 1995 on the Cost of Equity Capital*. (the PSRLA increased the cost of equity) JEFF P. BOONE, et al., *Litigation Reform, Accounting Discretion, and the Cost of Equity*, Journal of Contemporary Accounting and Economics, 2009 (2009). (the increase in the accounting discretion associated with the PSLRA increased the firm-specific equity risk premiums).

[55] STEPHEN J. CHOI, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J. L. Econ. & Org. 598(2006). (PSRLA reduced nonnuisance claims). MICHAEL A PERINO, *Did The Private Securities Litigation Reform Act Work?*, U. Ill. L. Rev. 913(2003). (statistically significant evidence suggesting that the PSLRA improved overall case quality at least in the circuit that most strictly interprets the Reform Act's heightened pleading standard).

[56] ZOE-VONNA PALMROSE & SUSAN SCHOLZ, *Restated Financial Statements and Auditor Litigation*, SSRN eLibrary (2000). WILLIAM G. HENINGER, *The Association between Auditor Litigation and Abnormal Accruals*, 76 Acct. Rev. 111(2001).

[57] *See supra* note 54. See also KHURANA & RAMAN. PAUL D. NEWMAN, et al., *The Role of Auditing in Investor Protection*, 80 Acct. Rev. 289(2005). VENKATARAMAN & WEBER. Contra, CHEE KEUNG KEVIN LAM & YAW M. MENSAH, *Auditors' Decision-Making Under Going-Concern Uncertainties in Low Litigation-Risk Environments: Evidence from Hong Kong*, 25 Journal of Accounting and Public Policy 706(2006). JOSEPH P. WEBER, et al., *Does Auditor Reputation Matter? The Case of KPMG Germany and ComROAD AG*, 46 Journal of Accounting Research 941(2008).

[58] *See supra* note ___.

[59] RAFAEL LA PORTA, et al., *What Works in Securities Laws?*, 61 J. Fin. 1, 7, 11 (2006).

[60] *See infra*, ___

[61] HOWELL E. JACKSON & MARK J. ROE, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. Fin. Econ. 207, 212 (2009).

[62] *See supra* __

liability was a mantra precisely in the legal and accounting literature of the 1990s, the years in which the Law & Finance literature started its investigations - which were to become immensely popular[63] and extensively critiqued.[64] Third, and more important, because auditors are historically a key figure in monitoring managers,[65] empirical studies provide evidences that investors rely on auditors as fraud detection tools[66] and auditors follow fraud detection procedures under SAS 99 and ISA 240.[67] Thus, the total absence of any auditor liability indices is stunning. Equally puzzling is the most popular system of corporate governance predictors developed by commercial firms, namely the RiskMetrics's Corporate Governance Quotient (CGQ) system.[68] It considers shareholders' ratification of management's selection of auditors but does not evaluate auditor liability.[69] Yet, as any litigator in this field knows well, auditor's role and liability are core issues in *ex post* evaluation of the firm's corporate governance system.

E. Assessment

The literature on audit litigation can be highly misleading. It is dominated by the US scenario[70] and investors' class actions against audit firms.[71] This has created tunnel vision

[63] LA PORTA, et al;RAFAEL LA PORTA, et al., *Legal Determinants of External Finance*, 52 J. Fin. 1131(1997);ANDREI SHLEIFER & ROBERT W. VISHNY, *A Survey of Corporate Governance*, 52 J. Fin. 737(1997);RAFAEL LA PORTA, et al., *Law and Finance*, 106 J. Pol. Econ. 1113(1998);RAFAEL LA PORTA, et al., *Corporate Ownership Around the World*, 54 The Journal Of Finance 471(1999);RAFAEL LA PORTA, et al., *Investor Protection and Corporate Governance*, 58 J. Fin. Econ. 3(2000);SIMON JOHNSON, et al., *Tunneling*, 90 Am. Econ. Rev. 22(2000);ANDREI SHLEIFER & DANIEL WOLFENZON, *Investor Protection and Equity Markets*, 66 J. Fin. Econ. 3(2002);SIMEON DJANKOV, et al., *The Law and Economics of Self-Dealing*, (2006).

[64] JOHN ARMOUR, et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, SSRN eLibrary (2008). SANJAI BHAGAT, et al., *The Promise and Peril of Corporate Governance Indices*, 108 Colum. L. Rev. 1803(2008);LUCIAN A. BEBCHUK & ASSAF HAMDANI, *The Elusive Quest for Global Governance Standards*, 157 U. Pa. L. Rev. 1263(2009);SOPHIE COOLS, *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers* 30 Delaware Journal of Corporate Law 697(2005).

[65] *See supra* ___

[66] JOSEPH F. BRAZEL, et al., *Investor Perceptions About Financial Statement Fraud and Their Use of Red Flags*, SSRN eLibrary, 17 (2009).

[67] TINA D. CARPENTER, *Audit Team Brainstorming, Fraud Risk Identification, and Fraud Risk Assessment: Implications of SAS No. 99*, 82 Accounting Review 1119(2007). T. JEFFREY WILKS & MARK F. ZIMBELMAN, *Decomposition of Fraud-Risk Assessments and Auditors' Sensitivity to Fraud Cues*, 21 Contemp. Acct. Res. 719(2004);STEVEN M. GLOVER, et al., *A Test of Changes in Auditors Fraud-Related Planning Judgments since the Issuance of SAS No. 82*, 22 Auditing: A Journal of Practice and Theory 237(2003);MARIA KRAMBIA-KAPARDISM, *A fraud detection model: A must for auditors*, 10 Journal of Financial Regulation and Compliance 266(2002);CAROL A. KNAPP & MICHAEL C. KNAPP, *The effects of experience and explicit fraud risk assessment in detecting fraud with analytical procedures*, 26 Accounting, Organizations and Society 25(2001);ROBERT J. NIESCHWIETZ, et al., *Empirical Research on External Auditors' Detection of Financial Statement Fraud*, 19 Journal of Accounting Literature 190(2000);MARK F. ZIMBELMAN, *The Effects of SAS No. 82 on Auditors' Attention to Fraud Risk Factors and Audit Planning Decision*, 35 (Supplement) J. Accounting Res. 75(1997);KAREN V. PINCUS, *The Efficacy of a Red Flags Questionnaire for Assessing the Possibility of Fraud*, 14 Accounting, Organizations and Society 153(1989);W. S. ALBRECHT, et al., *Auditor Involvement in the Detection of Fraud*, *in* Management Fraud: Detection and Deterrence (R K Elliote & Willingham eds., 1980).

[68] RISKMETRICS GROUP, CORPORATE GOVERNANCE QUOTIENT, http://www.riskmetrics.com/cgq (last visited ___, 2009).

[69] RISKMETRICS, NON-U.S. INDICATOR DEFINITIONS, supra note 42, ¶ 21, at 13 ("Shareholders should be permitted to ratify management's selection of auditors each year.").

[70] Data concerning other markets are rare:

[71] This is individually well known to many researchers. See for example DYE, *Incorporation and the Audit Market*, at 78. (noting that, with reference to whether is it advisable to let auditors adopt the limited liability partnership, the European experience is not a useful benchmark for comparisons, as there are too many

within the audit literature. The reported problem of the US scenario was that actions against auditors were (at least until 1995) too easily brought to coerce a settlement. However, this scenario had nothing specific concerning the auditor, except that in many cases the auditor was the "deep-pocket", as the company was bankrupt and the plaintiff's efforts were entirely addressed against the external auditor. In other words, excessive litigation against the auditor was treated by the accounting literature as a systemic problem of the pre-1995 American auditor liability regime instead of a part of the larger picture concerning securities class actions and distorted incentives in US private enforcement.[72]

The studies that go beyond the US border reach unclear results as to the role of litigation and civil liability.[73] Cross-country analyses have led to different results[74] and are spoiled by the usual, unreliable methods of classifying jurisdictions that typify generalizations made in the Law & Finance literature.[75]

None of the leading articles in the economic analysis of the litigation crisis offer a clear background to auditor liability regimes. When the author distinguishes cases, the differences in liability regimes are nevertheless not explained. Litigation (in the US) is taken as a phenomenon that offers data, not as a subject in itself. In short, reading the enormous quantitative economic literature on the subject sheds no light as to what auditor liability really is. One might also suspect that economists' problems in understanding the underpinnings of auditor liability regimes explains why corporate governance predictors have largely escaped the issue.

II. AUDITORS' LIABILITY TO THE COMPANY (REGIME 1)

Auditors serve different interests at the same time. In order to understand the topic, one should analyze the nature of these interests and how they are treated in terms of auditor liability. This kind of analysis must begin with the interests of shareholders, who are the primary constituent, at least historically.[76]

---

differences between the US and European countries' legal environments to make ceteris paribus arguments plausible).

[72] About which see for example ALEXANDER. JANET COOPER ALEXANDER, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487(1996). PAUL G. MAHONEY, *Precaution Costs And The Law of Fraud in Impersonal Markets*, 78 Va. L. Rev. 623(1992). ELLIOTT J. WEISS & JOHN S. BECKERMAN, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053(1995). PAUL G. MAHONEY, *The Exchange as Regulator*, 83 Virg. L. Rev. 1453(1997);ADAM C. PRITCHARD, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 Va. L. Rev. 925(1999). STEPHEN J. CHOI, *The Evidence on Securities Class Actions*, 57 Vand. L. Rev. 1465(2004). CHOI, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?* TOM BAKER & SEAN J. GRIFFITH, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. Pa. L. Rev. 756(2009).

[73] Cf. LAM & MENSAH. WEBER, et al.

[74] Cf. J. FRANCIS & D. WANG, *The joint effect of investor protection and Big 4 audits on earnings quality around the world*, 25 Contemp. Acct. Res. 157(2008). JONG-HAG CHOI, et al., *Audit Pricing, Legal Liability Regimes, and Big 4 Premiums: Theory and Cross-country Evidence.*, 25 Contemp. Acct. Res. 55(2008).

[75] For this critique of the L&F literature see -----

[76] The US literature stresses that the primary constituents are investors: *see, e.g.*, LAWRENCE A. CUNNINGHAM, *Securitizing Audit Failure Risk: An Alternative to Caps on Damages*, 49 William & Mary L. Rev. 711, 713 (2007). The reason is that external auditors are considered shareholders' watchdogs in cases of embezzlement only: *see infra* ___

A. The Auditor as the Shareholders' Watchdog (England)

Shareholders and partners need to monitor managers to be sure that no breach of contract occurs.[77] The auditor was used right from the very beginning of company history as a tool to control managerial opportunistic behavior.[78] The auditor looked for unauthorized expenses, embezzlements, and checked the accounting data prepared by the management.[79] In short, he was an inspector.[80] Initially, auditors were chosen among directors, assistants[81] or shareholders, which formed shareholders' committees.[82] Later on they became external professionals, who were not necessarily accountants.[83]

The traditional English auditor's role of a watchdog appointed by the shareholders was followed by a series of legislation in England that, after the "railroad mania", started to mandate the audit. The lineage of companies acts commenced with the Joint Stock Companies Act of 1844 and led to the Companies Act of 1929, which required an auditor's report on the profits of the company of the last three years to be part of any prospectus used to sell shares, thereby introducing for the first time the prospectus audit into the history of securities regulation.[84] Under the complex stream of companies law statutes, the auditor was always considered exclusively as an agent of the shareholders collectively.[85] This exclusive role remained untouched by the appearance of the prospectus audit. Auditors were appointed and their remuneration decided by the shareholders; they could employ an accountant at the company's expenses to carry out their duties and report on such to shareholders at the general meeting.[86] The auditor's role was to act antagonistically in regards of the directors, even

---

[77] External auditors are part of a varied menu of corporate governance alternatives and complementarities: see, e.g., SADOK EL GHOUL, et al., *External versus Internal Monitoring: Do Western European Firms Rely More on Big Four Audits in the Absence of Multiple Large Shareholders and Families? at* http://ssrn.com/abstract=1373808. (providing evidence that firms with multiple large shareholders whose presence brings valuable cross-monitoring are less apt to choose a Big Four auditor, and that family control and management is associated with lower demand for high-quality auditors).

[78] ROSS J. WATTS & JEROLD L. ZIMMERMAN, *Agency Problems, Auditing, and the Theory of the Firm*, 26 J. L. & Econ. 613(1983).

[79] GERARD HERTIG & HIDEKI KANDA, *Creditor Protection*, *in* The Anatomy of Corporate Law 91, (Reineer et al. Kraakman ed. 2004). assert that auditors are employed simply to check that "company's financial statements reflect the laws and accounting standards of the jurisdictions in which it is domiciled or its securities trade." This does not reflect the story of auditors, and the law of the US, UK, Italy and Germany. The same is true with regards to the assertion that auditors are primarily engaged to inform management of inefficiencies and irregularities (watchdog for the management): WERNER F. EBKE, *In Search of Alternatives: Comparative Reflections on Corporate Governance and the Independent Auditor's Reponsibilities,* 79 Nw. U. L. Rev. 663, 674 (1984).

[80] COFFEE JR., Gatekeepers: The Professions and Corporate Governance 110.

[81] WATTS & ZIMMERMAN, 626-7.

[82] As Watts and Zimmerman observes, "when the U.K. Companies Act of 1844 required directors to keep accounts and required those accounts to be audited by persons other than the directors (or their clerks), Parliament was merely incorporating into the law a version of a practice that had existed for six hundred years." Id. at 626.

[83]

[84] For analysis of the various companies acts from an audit perspective see SEAN M. O'CONNOR, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. Rev. 741, 756-775 (2004). As to the role of prospectus liability in muddling the auditor's role, *see infra* ___-

[85] It must be added that an English statute created for the first time a direct relationship between directors and auditors. It is the Directors Liability Act 1890, allowing directors to defend themselves against investor suits concerning prospectuses on the grounds that they – the directors – had in good faith relied on the expert reports of others. See *infra*, ____

[86] O'CONNOR.772.

though auditors were paid by the company.[87] This shareholders' watchdog role is still testified by the *Caparo* case,[88] in which the House of Lords firmly re-affirms that the auditor is an agent of the shareholders, not as investors but as persons who have delegated the day-to-day management of the company to the directors and who face a collective action problem in monitoring them, and thus charge the auditor to be a check upon directors.[89] The shareholders of the company "have a collective interest in the company's proper management … indistinguishable from the interest of the company itself and any loss suffered by the shareholders … will be recouped by a claim against the auditor in the name of the company."[90] Accordingly, the auditor is liable to the company as the entity that unifies shareholders' interests. Under English common law, the auditor owes no duty to third parties.[91]

B. The US experience

1. The 'Imbroglio'

The path of the audit profession in the US, according to some recent studies, was notably different from the English one, even though English auditors were invading the US to serve the interests of British investment syndicates.[92] For various reasons,[93] the US perception of the auditor role was that the auditor was serving multiple principals: the company, the investors, the general public. This perception was fuelled by US accountants, eager to gain public acceptance and social recognition as intellectual professionals (in the US "accountant" and "auditor" became coextensive terms).[94] As to the relationship with the corporation, US auditors were not appointed by shareholders and apparently were not clearly seen as the shareholders' watchdogs. Federal securities law did not mandate shareholders' appointment of auditors.[95]

A recent commentator who has analyzed the history of auditors in the US between 1880 and 1934 has written that what came out was an imbroglio, where external auditors are hired to perform a service on behalf of the client company, "with a host of implied duties to creditors, directors, and the 'investing public', not to mention a duty to shareholders and possibly even employees."[96] This imbroglio even led many commentators and auditors to discuss the auditor' role as one of informing management of irregularities and inefficiencies. It is the "watchdog for management" role, which to the best of my knowledge is totally unheard of in other countries.[97] Accordingly, some economist do not even mention auditors when discussing the monitoring of the board.[98] This confusion, which will be discussed and

---

[87] In *Caparo* Judge Bridge quotes the passage in which Judge Vaughan Williams wrote in Re Kingston Cotton Mill Co [1896] 1 Ch 6 at 11: "No doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them."

[88] Caparo Industries plc v Dickman and others, [1990] 2 AC 605.

[89] Lord Bridge of Harwich, quoting Judge Bingham in Bingham LJ in the Court of Appeal ([1989] 1 All ER 798 at 804

[90] Lord Bridge of Harwich

[91] I will comment later on how Stone & Rolls exposed that the English legal landscape in this area is only in appearance conceptually clear. I will also deal with the question of why, in this purely contractual scenario, liability limitations were not allowed or adopted until the recent provision under which the shareholder meeting can decide whether to limit auditor's liability or not. *See infra* ___

[92] Carey, 21-22, 27-28

[93] See O'CONNOR, 775-789.

[94] Carey, 172 *et seq*. (da Fiflis, nota 281)

[95] The exception was the Investment Company Act of 1940: HAWES, 13-15.

[96] O'CONNOR, 824.

[97] See EBKE, 674.

[98] For instance JEAN TIROLE, The Theory of Corporate Finance 28 (Princeton University Press. 2006).puts auditors with other 'eyeballs' and do not consider them watchdogs.

analyzed further on, has led the US courts to adopt concepts that sounded very peculiar to European lawyers, at least until *Stone & Rolls* imported some of those concepts into Europe.

2. *Doctrines*

a) Imputation Defense and In Pari Delicto Doctrines

In US fraud cases, the auditor can successfully attribute knowledge of the fraud committed by its client's employee to the client, even if the auditor did not conduct the audit in accordance with professional standards and was, therefore, negligent. The assumption is that the company cannot sue the auditor because the latter cannot be considered to have caused the damage when the wrongdoing was already known to the company's managers. If the fraud was committed by the managers, the auditor can assert that the managers were the company's representatives and therefore the company must blame itself: the company and the auditor were *in pari delicto*, and a wrongdoer cannot recover from a mutual wrongdoer.[99] In short, knowledge and conduct of management are entirely imputed (attributed) to the company.[100]

b) The Rejection of the Innocent Insider Exception

US courts have discussed the so called "innocent insider exception", according to which the presence in the company of at least one person with the ability to bring an end to the fraudulent activity in the board (or amongst shareholders) would operate as an exception to the imputation defense. [Expand] The argument invoked against the exception is that it would prevent the board from actively monitoring management fraud, as the board would be induced to take a passive role, relying exclusively on the auditor's 'whistle'.[101]

c) Adverse Interest Defense

The imputation defense[102] is grounded both in agency and causation doctrines[103] that are puzzling for a foreign observer who assumes that monitoring the management is "the very thing" auditors have to do.[104] However, the imputation defense cannot be wholly understood if its specific counter-defense is not considered. In order to win the defense the client company must invoke the 'adverse interest defense, asserting that the managers acted adversely to the principal, entirely for their own purposes, with the principal retaining no benefit from the managers' misconduct.[105] The adverse exception wins over the imputation

---

[99] When the audited company management's fraud in not alleged, the same logic that governs the *in pari delicto* defense leads to contributory negligence rules. The applicability of contributory rules in auditor liability cases is discussed: see ROBERT A. PRENTICE, *Can the Contributory Negligence Defense Contribute to a Defusing of the Accountants' Liability Crisis?*, Wisc. Int. Law J. 359(1995).

[100] The management acts on behalf the company and represents the company: its acts and knowledge are imputed to the company and thereby, indirectly, to its shareholders. This is the imputation theory, that can be found, under a different name, basically in every country and it is based on agency principles. MATTHEW G. DORÉ, *Presumed Innocent Financial Institutions, Professional Malpractice Claims, and Defenses Based on Management Misconduct,* , 1995 Colum. Bus. L. Rev. 127, 133 (1995).

[101] Cenco, 686 F.2d at 454-56.

[102] In professional liability cases the imputation defense is mentioned as the "Wagoner Rule", by the name of a famous case in which it was used: Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114.

[103] However, there is also a law & economics' argument for the imputation defense, referred by Judge Strine in In re American International Group, Inc., Consolidated Derivative Litigation, 976 A.2d 872, (Ch. Del. 2009). 877 (one of the primary purposes of the in pari delicto doctrine is to prevent courts from having to engage in inefficient and socially unproductive accountings between wrongdoers). Judge Strine's reasoning is spelled out at 893-894. This reasoning does not concern auditors, as the same judge makes it clear in ln re American International Group, Inc., Consolidated Derivative Litigation, 965 A.2d 763, (Del. Ch. 2009).at 831, nt. 247.

[104] Lord ___, *Stone & Rolls*

[105] § 282 Restatement (Second) of Agency

defense even though the client was negligent in monitoring its own people[106] and also if there was an unauthorized audit interference.[107]

The imputation defense can be conceptualized also as a presumption that the principal (namely, the company) is in control and knows what the agent is doing or – the other side of the same coin – that the agent (namely, the manager) properly discharges his duty of disclosure to the principal. The adverse interest exception rebuts this presumption, since "[the agent] cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose."[108]

d) Sole Actor Rule

If the agent and the principal are the same persons within a single corporation (for example, the single director and the controlling shareholder), the "sole actor rule" invalidates the "adverse interest exception" and brings the parties back to the imputation defense: as a court has written, "this rule imputes the agent's knowledge to the principal notwithstanding the agent's self-dealing because the party that should have been informed was the agent itself albeit in its capacity as principal."[109] The rule cannot be applied if in the company there was the presence of at least one person with the ability to bring an end to the fraudulent activity at issue. [110] The sequence is well represented in the following passage of *Sharp*[111]:

> "Sharp [*the company*] takes the position that even if the Spitzes' fraudulent conduct were imputed to Sharp by operation of the Wagoner rule [*imputation defense*], Sharp would still have standing to maintain this action against KPMG [*the auditor*] because the facts of this case fit within the adverse interest exception to the Wagoner rule. KPMG takes the position that, even if the Spitzes' fraud falls within the adverse interest exception, the Wagoner rule is invoked because of the sole actor exception to the adverse interest exception to that rule."

3. Two rationales for the imputation defense and their critique

a) The (Usually) Impossible Distinction between the Managers' Interest and Company's Interest when Financial Data Are Misstated

The imputation defense and its exception are aimed at preventing the company cherry-picking the effects of management misbehavior, by keeping the good and asking the auditor for restitution of any negative consequences in the form of damages.[112] However, in financial fraud cases the problem is precisely to establish, firstly, when the managers acted entirely for their own purposes and, secondly, that the company obtained no benefit from the managers' misconduct. Analysis of all the major financial scams shows that it is always very difficult to distinguish cases in which the managers merely embezzled the company from cases in which the company was turned – to use Judge Posner's metaphoric language in *Cenco* – into "an engine of theft against outsiders – creditors, prospective stockholders, insurers, etc."[113] Financial scandals teach that managers usually misstate financial data both to take a personal advantage – for instance by gaining on stock options or retaining their position, income and perks – and to grant some perceived benefit to the company (i.e. its shareholders). This benefit could be of different nature. It could be an attempt to keep afloat a firm that is sliding

[106] Against the adverse interest exception the defendant can still raise the "sole actor rule":

[107] ANDREW J. MORRIS, *Clarifying the Imputation Doctrine: Charging Audit Clients with Responsibility for Unauthorized Audit Interference*, 2001 Colum. Bus. L. Rev. 339(2001).

[108] Center, 66 N.Y. at 784; Cepa Consulting, Ltd. v. King Main Hurdman (In re Wedtech Sec. Litig.), 138 B.R. 5, 9 (S.D.N.Y. 1992).

[109] In re Mediators, Inc., 105 F.3d 822, 827 (2d Cir. 1997).

[110] Breeden v. Kirkpatrick v. Lockhart L.L.P., 268 B.R. 704, 710 (S.D.N.Y. 2001).

[111] Sharp case, 21-22

[112] From a European perspective, the couple "imputation defense-adverse interest exception" can probably be reconceptualised in terms of causation and damages.

[113] Cenco, 15

into insolvency; it could be a favorable loan, or the use of the company's over-inflated shares to buy up other companies.[114] Insiders misrepresent the company's financial reports to enlarge the firm's activity range and dimension, and get private benefits from this.[115] To put it in a different way, with the words of a renowned financial economist:

> "accounting manipulation serve multiple purposes. First, they increase the apparent earnings and/or stock price, and thereby the value of managerial compensation. … Second, by hiding poor performance, they protect managers against dismissals or takeovers … Third, accounting manipulations enable firms not to violate bank covenants, which are often couched in terms of accounting performance. Lastly, they enable continued financing."[116]

When the financial fraud allows the company to tap money that it otherwise would not have been able to access, the original formulation of the deepening insolvency doctrine[117] may help courts to assert that the prolonged artificial solvency of a company benefits insiders, not the company.[118] The argument is that since the fraud deepened the insolvency and a company is not a natural entity, it is not in the self-interest of the company to prolong its own survival, but it is purely in the self-interest of insiders. This specific formulation of the deepening insolvency doctrine bars imputation.

b) Imputation Defense as a Corporate Governance Tool and Its Problems

The imputation defense is also conceptualized, with regards to auditor liability, as a corporate governance tool, which forces shareholders to implement an adequate corporate governance system and, in particular, to choose a vigilant monitoring board where independent directors have a true role.[119] There are two problems with this view. First, it assumes that independent directors are better positioned to ferret out fraud than auditors.[120] Second, it does not explain why mandatory audits are required. A corollary of the corporate governance explanation of the imputation defense is either that auditors are a tool to detect

---

[114] Cenco; J Finance 2009

[115] This arguments are known to US courts, but do not dent the strength of the imputation defense, at least in cases where third-parties different from the auditor are involved: "… there is little doubt that in almost every situation where a corporate insider causes a corporation to engage in illegal acts so as to increase the corporation's actual or reported profitability, the insider will have personal interests that might arguably also be advanced if the illegal scheme succeeds. … Allowing corporations to sue co-conspirators whenever such an argument can be ginned up would give corporations a gaping exception from the *in pari delicto* doctrine, putting them on a different plane from actual human beings" In re American International Group, Inc., Consolidated Derivative Litigation..892.

[116] TIROLE. 20

[117] In re Investors Funding Corp. of N.Y. Sec. Litig.

[118] J.B. HEATON, *Deepening Insolvency*, 30 Iowa J. Corp. L. 465, 470-472 (2005).

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

[120] See on this point Judge Strine's critique in ln re American International Group, Inc., Consolidated Derivative Litigation. …. At 831 nt. 146: "Furthermore, audit firms are paid sizable fees for the thousands of hours their professionals spend on their duties at each issuer. ... The audit firm spends many more hours on the task than independent directors do, and are typically far better compensated. Notably, in corporate law, independent directors are entitled to rely in good faith on advice from the auditors that corporate books and records are accurate and GAAP-compliant and that corporate internal controls are adequate. *See 8 Del. C. § 141(e)* (protecting a director when she relies on "information, opinions, reports or statements" presented to her by someone she reasonably believes to have "professional or expert competence" in the matter). *Cenco* has this relationship backwards and assumes that as between independent directors and auditors, the former are better positioned to ferret out fraud. *Cenco*, 686 F.2d at 456. Doubtless both groups face challenges in doing so, and, likewise, both are positioned to reduce the risk of fraud in various ways, but I question the soundness of premising a legal rule on the belief that, in a simplistic binary choice, independent directors are better equipped to detect high-level fraud than a company's auditors. I also do not understand why what is, at most, an audit committee's negligence should totally bar the corporation's recovery against a professionally negligent agent."

the most simplistic misconduct against the company or serve exclusively third-party investors, not the company and its shareholders. However, the latter is never stated, as this would go against the history and the functions of auditing, as well as the strict rules that under federal US law govern liability towards third parties.[121] Therefore, in the US auditors are the shareholders' watchdogs exclusively in the most extreme cases of embezzlement.Back to England: Stone & Rolls

If at first sight the English approach to auditor's liability appears linear compared to the US one, it is no longer in the wake of the *Stone & Rolls* case, which first partly imported the US imbroglio and second ended up in the quagmire of the relationship between the auditor and the company's creditor.

4. The Stone & Rolls Case

In *Stone & Rolls* an auditor raised for the first time in English history the sole actor rule, even though dressed in a different way to adapt it to the concepts and language of English common law. Stone & Rolls (S&R) was under the complete control and effective ownership of Mr. Stojevic, who obtained from banks increasingly large amounts of money under letters of credit providing for deferred payment. The banks thought they were financing commodity trades, but the documents were forgeries. S&R got the money without waiting for the expiry of the deferred periods by assigning or forfeiting the letters of credit. The funds were then partly siphoned off to third parties related to Mr. Stojevic, or partly used to manage a Ponzi-scheme against the same banks, to get access to larger and larger letter of credits. At a certain point the scheme ceased, and the banks were left with unsecured and substantial losses.[122] The company's liquidator sued the auditor, Moore Stephens (MS).

5. The Decision

MS raised the defense that S&R's claim was founded on its own fraud and could not succeed in light of the defense commonly described by the Latin maxim "*ex turpi causa non oritur actio*". The auditor's defense was the British version of the US "imputation defense" and "sole actor rule" as counter-defense to the "adverse interest exception." [Clarify] Two Lords rejected MS's arguments, but the other three accepted them, and MS won the case.[123]

The auditor won the case because S&R was a one-man company. Accordingly, the three Lords who decided in favor of MS saw no shareholders to protect, and the argument that the "very thing" that auditors have to do is to monitor management and report fraud was not seen as persuasive in the absence of innocent shareholders to be protected.[124]

The three Lords that formed the majority were particularly worried to go against *Caparo*[125] by introducing a hidden creditors' action against the auditor through the liquidator's claim.[126] In fact, the action's proceeds would have been used to repay the

[121] See again Judge Strine's at nt. 247.

[122] See _____ [2002] EWHC 2263 (Comm); [2003] 1 Lloyd's Rep 383.

[123] The decision was immediately commented by the financial press as a sign of what might happen to Madoff's auditors.

[124] Moreover, one Lord did not consider fraud detection as the "very thing" that auditors are expected to do: "The detection of fraud is only a small part of the total statutory and common law duties owed by auditors, and the discovery that an apparently respectable and prosperous company is carrying on activities that are wholly fraudulent must be a very rare occurrence": Lord Walker, at 193, which seems to be influenced by the US imbroglio. Notwithstanding this, the second part of the above quotation appears to have little or no logical connection with the assumption contained in the first part.

[125] See infra,

[126] I have strong sympathy for Lord Mance's observation that "within the majority speeches, although their reasoning differs, there can be found … an inversion of the decision in Caparo – whereby the denial to creditors in that case of recovery against auditors because the company would have its own claim is deployed to

defraued banks, as the company's loss (the money siphoned off) was the creditor's loss.[127] On this point I will elaborate later on.[128]

Moreover, there was the concern that the claim could go to the benefit of banks without any chance for the auditor to invoke contributory negligence.[129] Furthermore, there was also the worry that the manager-sole shareholder or, more in general, any complicit shareholder involved in the scam could benefit from the fraud at the expense of the auditor.[130]

6. *Some General Comments about* Stone & Rolls

The House of Lords' position, strongly influenced by the US experience and inattentive to auditors duties to report,[131] creates more problems than it solves. It is not clarified why the company could have sued the director and not the auditor, who is his guardian.[132] It is not clear what the reasoning would have been if, instead of defrauded banks, innocent bondholders had been implicated. It is not clear how many innocent shareholders are required in order to reactivate auditor's liability and dispose of the *ex turpi causa* defense. It is by no means clear how the principle that companies have their own legal personality fits with the idea that auditor liability towards the company depends on the shareholders' state of mind and their degree of implication in the fraud. As Lords Mance and Scott have pointed out, the decision actually lifts the corporate veil.[133]

In his dissenting opinion, Lord Mance notes that "the world has sufficient experience of Ponzi schemes operated by individuals owning 'one man' companies for it to be questionable policy to relieve from all responsibility auditors negligently failing in their duty to check and report on such companies' activities".[134] Lord Scott qualifies the majority's decision an example of bad jurisprudence.[135] My view as an outsider to the common law system is that *Stone & Rolls* is also a by-product of the American jurisprudence on the issue as well as of the rhetoric aimed at protecting auditors from liability as far as possible; both elements risk transforming a statutory watchdog into a simple mandatory reader of financial statements. More importantly from this article's perspective, the decision offers evidence of the weaknesses of the straightforward English approach that was regarded as making such a

deny the company's claim against auditors because this would indirectly benefit the company's creditors" (§ 207).

[127] Lord Phillips, § 5: "The final reason of common sense that predisposed me against this claim was one which would not, unlike the other two, occur to the man in the street but might occur to a student with knowledge of the principles of the law of negligence. Looking at the realities, this claim is brought for the benefit of banks defrauded by S&R on the ground that Moore Stephens should have prevented S&R from perpetrating the frauds. Why, if this is a legitimate objective, should the banks not have a direct cause of action in negligence against Moore Stephens?"

[128] Infra, ____

[129] As Lord Phillips has written "it would not seem just for a company to make a full recovery of damages against auditors for the benefit of banks which have themselves negligently failed to carry out appropriate 'due diligence' before advancing monies to the company." Lord Phillips continues by observing: "Lack of care on the part of the banks in their dealings with S&R ought to be taken into account for the purposes of contributory negligence. Yet such lack of care could not be prayed in aid by S&R in answer to claims framed by the banks in deceit – Standard Chartered Bank v Pakistan National Shipping Corpn (Nos 2 and 4) [2002] UKHL 43; [2003] 1 AC 959. Nor is there any obvious mechanism by which such lack of care could be relied upon by Moore Stephens in answer to the claim brought by S&R".

[130] This preoccupation, however, I find difficult to understand given that the auditors would be entitled to recover immediately any proceeds paid to the guilty shareholder, who would be, together with the manager, a primary violator. The point is briefly covered by Lord Mance at 251-255.

[131] Lord Mance, in his dissenting opinion, points out the duties to report under SAS 110 and the Companies Act: see § 269-270.

[132] Lord Mance elaborates the issue much better than I can do: § 231 ff.

[133] See § 118 and 250.

[134] At § 206.

[135] At § 123.

valuable contribution to the issue of auditor liability. In fact, the decision shows how difficult it is to distinguish damage to the company from damage to the creditors when the company's assets have been siphoned off, the company has gone bankrupt and any recovery of those assets is destined to go to the benefit of the creditors.

C. Italy

Italy offers a radically different scenario.

1. The Framework

Italian company law originally opted for the inside statutory auditors model ("collegio sindacale"), which can probably be considered an evolution of shareholders' committees.[136] Inside statutory auditors were to be primarily seen, in the words of one of the major Italian commentators of those early times, "the permanent controllers of the directors, on behalf of the shareholders, who are not able to monitor them personally."[137] Later on, the law moved towards an outside auditors' model, which is now the default model for public companies and the mandatory one for listed companies.[138] Under this model, companies have inside statutory auditors to monitor management and outside auditors in charge of traditional audit tasks.[139]

2. Why There Is No Trace of the Imputation Defense in Italy? Four Reasons

In Italy there is nothing that can be compared to the imputation defense in an audit litigation context. There are probably three main reasons. First, with regards to inside statutory auditors the idea that they could escape liability on the grounds of some sort of imputation theory was unconceivable, because the inside statutory auditor committee was itself a body of the company. When the system moved towards the outside auditor model, it was no way viewed as a means of offering the outside auditor comparatively better treatment.[140] The external auditor is not a company's body, but a mandatory external watchdog that fulfils identical needs with regards to financial reports. From a functional perspective, Italy's experience offers evidence that the inside/outside dualism is artificial.[141] Second, Italy has a rule of comparative fault. The concept of contributory negligence, which can protect auditors in common-law litigation,[142] is unknown. [CLARIFY] Auditors (whether insiders or, later on, outsiders) are there to monitor the directors and there is no way they can reduce their liability by asserting that they were mere mutual wrongdoers. Third, in a country where the agency problem lies in the relationship between the controlling shareholder (coalition) and minority shareholders,[143] the idea that managers can simply think to embezzle the company without driving the company to expand its operation would be considered extremely naïve. The dimension of the company is crucial to enlarge the controlling shareholder's private benefits of control. Financial information is a key tool of corporate

---

[136] Recently, the law opted for a mixed model, with statutory auditors plus independent professional auditors.

[137] CESARE VIVANTE, Trattato di diritto commerciale. Vol. II. Le società commerciali 277 (Vallardi. 1929).

[138]

[139] For a more detailed description of Italian law, which also let company to adopt a German-like two tier structure or an Anglo-American one without inside auditors see GUIDO FERRARINI, et al., *Company Law Reform in Italy: Real Progress?*, 69 Rabels Zeitschrift 658(2005).

[140] See also infra, ___

[141] This artificiality is a further expression of Coase's insights: RONALD H. COASE, *The Nature of the Firm*, Economica 4(1937).

[142] *See supra* ___ ????

[143] LUCA ENRIQUES & PAOLO VOLPIN, *Corporate Governance Reforms in Continental Europe*, 21 J. Econ. Persp. 117(2007).

governance, as management's decisions are constantly monitored by shareholders.[144] Italian law does not require that the agent has totally abandoned its principal's interest, since when siphoning off is present (at least, it is significantly present), any distinction between managers' (controlling shareholders') innocent interest for the company's success and managers' (controlling shareholders') self-interest is moot.[145]

If one conceptualizes the US doctrines in terms of causation and damages, from an Italian (and probably also a Continental European perspective) the issue is whether auditors (inside or outside auditors, as the case may be) could have prevented the company from losing money, putting shareholders or any potential reader of a public document such as the financial statements of the company on guard about what directors and managers were actually doing. No Italian cases, as far as I know, have ever differentiated between managerial misconducts that benefited the company and those that benefited the directors. The issue is simply one of damages. If innocent directors or inside auditors and shareholders had been made aware of what was happening, the presumption is that they would have reacted.[146] The innocent insider exception is therefore a concept that is generalized and well-accepted under Italian law, covering also minority shareholders, as they can report management's misconducts to courts, which can order an inspection and even appoint a trustee to temporarily manage the company.[147]

3. Parmalat's US Adventure

Ferrarini and Giudici have analyzed the Parmalat case and the decision of the Extraordinary Commissioner of Parmalat in Italian reorganization proceedings to sue auditors and banks in the US instead of Italy.[148] We pointed out that Italian liability rules are, at least on paper, tougher that the US ones and therefore that the commissioner's decision could not be explained on the grounds of Italian substantive rules. In particular, we stressed that the imputation defense and *in pari delicto* doctrines were a core difference as far as liability toward the company was concerned.[149] Indeed they were. Parmalat's claims against the auditors (and third parties like banks VERIFY AGAIN) were rejected and defendants' motion for summary judgment dismissing the complaints was granted under the *in pari delicto defense*.[150] Judge Kaplan decided that Parmalat had been unable to offer evidence that its previous managers had looted the company with total or even partial abandonment of the corporate interest. Italian less auditor-friendly substantive rules would have lead to a different result.[151]

[144] Kraakman. MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. L. Rev. 237(2009).

[145] A modern and financially oriented expression of this approach might be the one adopted, in the US literature, by FOX, 280 ("when the managers make decisions that result in the corporation's violation of a disclosure rule, the corporation is the primary victim of the violation, just as it is the party hurt by a director or officer's breach of a fiduciary duty. This is because … disclosure's primary role is to improve corporate governance and to lower the corporation's cost of capital by increasing the expected level of liquidity. The corporation's shareholders are thus the persons ultimately damaged by the violation because poor management and reduced liquidity reduce the value of shares").

[146] The auditor can always find persons that in theory at least are able to bring an end to the fraudulent activity, either by denouncing it to shareholders or asking for judicial intervention (Article 2409 Civil code).

[147] Art. 2409 C.c.

[148] GUIDO FERRARINI & PAOLO GIUDICI, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case in* After Enron (John Armour & Joseph A. McCahery eds., 2006).

[149] Id. at (183-4.

[150] In Re Parmalat Securities Litigation, 2009 U.S. Dist. LEXIS 85523, (S.D.N.Y. 2009).

[151] Probably an Italian court would also have considered differently the piece of evidence offered by Parmalat, namely the report of the "Guardia di Finanza" (Tax Police), the experts' reports offered by Parmalat and the statements of former Parmalat insiders, which Judge Kaplan did not consider admissible or sufficient evidence: id. 49-62.

D. Contractually negotiated caps to liability

1. The Issue

Despite the differences among the three legal environments, it is clear under all of them that the relationship between the company and the auditor is a contractual one. Accordingly, the question is why are contractually negotiated caps not admitted, with the exception of the new UK company law?[152] More generally, why is the whole field not left to the freedom of contract principle?

The issue is tricky and difficult to elaborate in intelligible ways. England now allows for limits to auditors' liability, but does not allow the adoption of clauses in the corporate constitutions limiting directors' liability. This represents a significant difference from Delaware General Corporation Law (and the laws of other states that followed Delaware on this path), whose section 102(b)(7) permits corporations to limit or eliminate the liability of directors for all but intentional or self-serving conduct.[153] Whether contractual limitations to auditors' liability are to be allowed is, however, the subject of current debate in the US.[154] In Italy both limitations and caps to auditors' or directors' liability are considered null and void.[155]

A first answer to the dilemma might be that many laws are afraid to reduce deterrence levels on directors and auditors, believing that at least *de facto* directors and auditors serve not only shareholders, but other stakeholders as well.[156] However, a better explanation is needed, especially in order to understand why before 2006 liability caps were not allowed also in the UK, where it was clear from the very beginning that the auditor acts exclusively as an agent of the company and therefore has no watchdog duties to third parties.[157]

2. Analysis: Shareholders' Collective Action Problem

The idea of an auditor acting as the shareholders' watchdog is difficult to put into practice in a large public company. The most obvious problem concerns the auditor's terms of engagement. In order to be a credible watchdog, the auditor should be elected, tenured and eventually dismissed by shareholders. However, the collective action problems that have induced shareholders to appoint auditors[158] re-surfaces when auditors have to be appointed: shareholders should spend time and resources in selecting the auditors and negotiating their engagement terms and price. There are no shareholders ready to provide this 'public good'.[159] In large, modern Anglo-American public companies shareholders are dispersed investors, rationally apathetic, ready to vote with management or with their feet.[160] The collective action problem that shareholders face is sorted out by the management itself, who selects the auditor on behalf of the company, negotiates the price and tables the audit firm's name for the shareholders to approve. In the end, the experience of big modern companies has shown also in the UK that the parties to be monitored are inevitably the ones that decide the shareholders' watchdog selection (as well as its tenure and dismissal).[161]

---

152 [Expand]

153153 BRIAN CHEFFINS & BERNARD BLACK, *Outside Director Liabilities Across Countries*, 84 Tex. L. Rev. 1385, at 1406 (2006).

154 Supra, nt. ___

155

156

157 Supra, ____

158 Supra, ___

159 MANCUR OLSON, The Logic of Collective Action: Public Goods and the Theory of Groups (Harvard University Press. 1965). [citare la pagina]

160 ANITA ANAND & NIAMH MOLONEY, *Reform of the Audit Process and the Role of Shareholder Voice: Transatlantic Perspectives*, 5 EBOR 223, 237 (2004).

161 See *infra*, ___

In order to limit the shareholder collective action problem there are two solutions: intermediate conduits and standardization. The audit committee is the conduit under recent English practice, following the US experience. In Italy the conduit is, with regard to listed companies, the inside statutory auditors' committee, which is the internal body of auditors that has been for a long time the substitute of Anglo-American external auditors and that now proposes to the general shareholder meeting the audit firm (even though in practice the managers still negotiate the fees with the audit firm to be proposed by the inside auditors).[162] The law, however, does not fully rely on these conduits, otherwise all the terms and conditions of the contract would be left to free negotiation, which is not what we actually observe. Accordingly, standardization is the other instrument used to reduce the collective action problem. Engagement terms have been standardized with the help of auditor associations, making part of the negotiations with the auditor easier.[163] Since liability rules are at the core of the contractual relationship between the company and the audit firm, a mandatory approach to liability - equivalent to full and compulsory standardization - expresses a clear disbelief in the capacity of conduits not to be influenced by the executives that the auditors will monitor and not to drive the shareholders meeting in the direction executives want.

3. The Intergenerational Problem

The current UK provision allowing the shareholder meeting to decide whether to limit the auditor's liability is a big step in relying on the conduits or shareholders' ability to overcome their collective action problems. However, there is a further problem to be sorted out: negotiation of the contractual terms and, in particular, of liability issues could give room to an intergenerational problem.[164] New shareholders can enter into the company relying on the monitoring role of the auditors, whilst old shareholders having a controlling stake in the company can modify *ex post* the engagement terms, for example by reducing the auditor's exposure to liability risk, in order to induce a reduction in the monitoring activity.[165] Needless to say, controlling shareholders might have an interest in reducing the auditor's monitoring when they want to expropriate minority shareholders through the managers, in situations typically where the manager and the controlling shareholder are the same person or the members of the same family. This could explain, with all the limits of *post hoc* rationalization, why shareholders' ability to modify auditors' performance is barred in countries, like Italy, where controlling shareholders have a significant influence, but recently allowed in countries, like the UK, where shareholders are widely dispersed and the intergenerational problem is thereby less worrying.

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

A. Ultramares *Legacy*

1. Judge Cardozo's Decision

The audit can create a spillover effect, as information originally addressed to the shareholders can go to the benefit of creditors as well. This means that the company can seek

162 Article 159 CFSA

163

164 Intergenerational problems are considered market failures. Compare ___

165 This is an expression of what has been coined 'the latecomer problem': FRANK H. EASTERBROOK & DANIEL R. FISCHEL, The Economic Structure of Corporate Law 32-34 (Harvard Univ. Press. 1991).

to use the audit to reassure creditors and get funds, as it is commonly observed in commercial practice. Is the auditor to be held liable if a creditor relies on its audit to finance the company? This is the classic *Ultramares* issue.[166] Touche was the auditor of Stern, a firm that borrowed large sums of money from banks and other lenders to finance its operations. Touche knew that Stern exhibited the certified balance sheet to potential creditors, and prepared thirty-two certified copies with serial numbers as counterpart originals. However, Touche did not know to whom in particular Stern would show the certified balance sheet. Ultramares was a factor and financed Stern, but the balance sheet was false and Stern went bankrupt. Ultramares sued the auditor for negligence and fraud.

Judge Cardozo decided that the auditor was not liable for negligence towards Ultramares, whereas it would have been liable if fraudulent intent had been proved.[167] The auditor was not in privity with Ultramares, as the latter had not employed the former. "If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." Accordingly, a negligence claim would be equivalent to a fraud claim. As Judge Cardozo points out: "The extension, if made, will so expand the field of liability for negligent speech as to make it nearly, if not quite, coterminous with that of liability for fraud."

The *Ultramares* decision has influenced all the following history of Anglo-American law on the issue. US State Courts or State legislation have developed and in many cases re-shaped the concepts analyzed by Judge Cardozo, adopting concepts like "near privity", "reasonable foreseeability" and similar, addressed at extending auditors' liability to cases in which it was perceived that the auditor knew or could have known that its audit was going to be used in order to induce a specified class of third parties to extend credit or invest in the company or in its shares.[168] In the UK, the House Lords explicitly followed the *Ultramares* principles in *Caparo*. The case concerned a shareholder who, relying on the certified accounts of a listed company, launched a takeover on the company to later discover that the accounts were false. The shareholder sued the auditor. The House of Lords decided that the auditor owes a duty to the company and not to creditors or to any single shareholder who "as a purchaser of additional shares in reliance on the auditor's report, [he] stands in no different position from any other investing member of the public to whom the auditor owes no duty." This assertion takes into consideration the fact that the accounts and the audit become public at the Register, but did not comport any responsibility of auditors to the public at large.[169]

2. The Floodgate Argument

Why is the collective action interest of shareholders so well recognized, in particular by English courts,[170] while those of creditors (e.g. *Ultramares*) or investors (e.g. *Caparo*) are not, under common law? The key concept is privity, and behind privity lies one of the more catchy and quoted phrases in modern private law: Judge Cardozo's reference to exposition to "liability in an indeterminate amount for an indeterminate time to an indeterminate class".[171] This is the floodgate argument, which dominates any scientific discussion of pure economic

[166] Ultramares Corp. v. Touche (1931) 174 N.E. 441.
[167] Cardozo was too lenient, according to GOLDBERG, 296.
[168]
[169] See the critique of Gower, ____
[170] See *supra*, nt. __
[171] Supra, __

loss.[172] The core idea is that if the auditor is liable towards any potential lender or investor approached by the company, he risks being exposed to unforeseeable costs in terms of liability, as in theory there is no limit to the capital a firm can demand and obtain from creditors or the market. By contrast, the auditor's potential exposition to risk for liability towards the company is limited, as it refers – one should assume – to assets that managers can misappropriate. Needless to say, this easy bipartition collapses if the auditor is exposed to wrongfully-incurred unpayable debt, because its liability might become unpredictable once again.[173] Accordingly, in the absence of a clear system that moves any liability onto directors and auditors, such as that in place in Europe with capital protection, the floodgate argument asks for auditors to be protected against liability for wrongfully-incurred unpayable debt.

The policy basis of the floodgate argument is spelled out by the Supreme Court of Canada in *Hercules*,[174] quoting two law articles:[175] increased insurance and litigation costs, consequent reduction of audit service supply and increase in the price paid by clients to incumbent auditing firms.[176] These arguments are based on assumptions that remain very difficult to be empirically proved and are, therefore, unconvincing. More easily, the floodgate argument is grounded in the problem of pricing the auditor's risk. The auditor cannot price its service, because it cannot know *ex ante* the liability risk he is going to face. It is very difficult for the company to credibly commit itself toward the auditor in order to sort out this problem, because once the information is provided (the audit), the company can use it freely, soliciting more and more potential creditors and investors to fund the company. Accordingly – this is the normative consequence of the floodgate argument – it is up to lenders to contract with auditors in order to buy protection.[177]

3. Where the Floodgate Argument Does Not Bite: Italy

The case of Italy shows that the assumptions that have been so convincing in the Anglo-American law are not universally valid. Italian law does not recognize the floodgate argument. Auditors can be held liable towards third parties (Article 2409-sexies C.c.; Article 164 Consolidated Financial Services Act, "FSA"). The reasons are probably threefold.

First, inside statutory auditors were (and still are) an internal body of the company which had the purpose of monitoring directors from within the company. Once it was agreed that directors were to be made liable for damages incurred by creditors and investors who have relied on the financial statements prepared by them, it was difficult not to put inside statutory auditors in the same position. As insiders, indeed, they can less persuasively state that they could not expect the financial statements to be used in order to induce creditors to

172 Cf. MARIO J. RIZZO, *A Theory of Economic Loss in the Law of Torts*, 11 J. Leg. Stud. 281(1982). (arguing that pure economic loss is not granted under common law when the litigation costs exceed the expected value of recovery or the costs of channeling the losses through the damaged party); W BISHOP, *Economic Loss in Tort*, 2 Oxford Journal of Legal Studies 1(1982). (analyzing the pure economic loss problem in the light of social cost and wealth transfer effects);

173

174 [1997] 2 S.C.R. 165.

175 BRIAN R. CHEFFINS, *Auditors' Liability in the House of Lords: A Signal Canadian Courts Should Follow*, 18 C.B.L.J. 118, 125-127 (1991). IVAN F. IVANKOVICH, *Accountants and Third Party Liability - Back to the Future*, 23 Ottawa L. Rev. 505, 520-521 (1991).

176 For similar arguments in the 1980s see EBKE.

177 It must be pointed out that unpredictability is not an issue with regards to management liability, because directors use the false accounts to misrepresent the company's situation and attract investments and credit, whereas the auditor does not know with precision to whom the management is going to present the false accounts. When the auditor should know that its attestation will reach a certain group of persons, the various common-law doctrines I have already mentioned apply ("near-privity", "reasonable forseeability" and the like). Thus, both the manager and the auditor are shareholders' agents, but the former is in a very different situation from the latter because he knows what is he going to do with the false or negligently prepared statements, whereas the external auditor may have an idea but not a precise perception of the risk taken on.

fund the company and, more importantly, that they cannot foresee this risk and perceive its monetary dimension.[178] This approach was passed on to external auditors, without too many distinctions between the two kinds of auditors and their position vis-à-vis the company.[179]

The second reason is the poor enforcement of private law. The risk of a litigation crisis and exposition to gigantic and unforeseeable liability cannot be taken seriously in a country where private enforcement is so ineffective, contrary to what the Final Report states.[180]

The third reason is probably connected (as already mentioned, *post hoc* rationalization is always a risk) to corporate governance issues. In a country where companies are largely dominated by controlling shareholders, manager embezzlement's risk is substituted by the larger risk that the controlling shareholders will siphon-off the company assets, and companies tap capital through banks and other lenders more than markets, auditors could not play precisely the same role as played in the UK or the US to the benefit of dispersed shareholders. Creditors' protection was certainly perceived to be more important, and the fact that financial statements were subject to publicity was easily considered evidence of their public value.[181] Accordingly, the Italian discussion was always dominated by the need to extend directors' and statutory auditors' liability in order to individually protect creditors from reliance on false accounts.[182]

B. The Floodgate Argument Problem: The Treatment of the Insolvent Company's Creditors

1. The Stone & Rolls Quagmire

The easy distinction between the company and third parties (to which the floodgate argument apply) collapses in an insolvency scenario, as *Stone and Rolls* shows. Recall the Lords' preoccupation not to leave the proceeds of the liquidator's action on behalf of the company to go to the benefit of the defrauded creditors.[183] This preoccupation shows that in an insolvency scenario is impossible to draw a clear line of division between loss to the company (i.e., its shareholders) and loss to the creditors as a class. As Judge Scott points out in *Stone & Rolls*, there is "a difference between a cause of action in negligence brought by a solvent company and a similar cause of action brought by an insolvent company. In the former case any damages recovered will benefit the shareholders; in the latter case the damages will benefit the creditors."[184] The real issue is therefore whether an auditor must be held liable to the company "for failure to pick up a fraudulent scheme rendering it increasingly insolvent."[185] It is obvious that if its liability were to go to the benefit of the creditors, at a certain moment in time the auditor would be actually asked to protect not only the shareholders, but indirectly also the creditors (as an undistinguished class). By contrast, if the auditor owes exclusively a duty to the company's shareholders, when the company it is not in a position to distribute the proceeds to the shareholders the auditor would be free from

178 Indeed, the 1942 Civil code stated at Article 2395 that directors are liable towards third parties. It said nothing about statutory auditors, but legal commentators started to assert that the rule was a general principle of our tort law (accordingly, the pure economic issue was totally bypassed) and that it should be applied by analogy to statutory auditors. The 2003 amendment to the company law part of the Civil code has stated that statutory auditors (and external auditors) are liable as well towards third parties under Article 2395.

179 Supra __

180 Supra, nt. __

181

182

183 Supra, ___

184 § 119.

185 Lord Mance, § 268.

liability.[186] The House of Lords could escape from this swamp thanks to the fact that the audited client was a one-man company, thereby applying the imputation defense and rejecting the adverse selection exception. Whether the auditor has to be held liable where the company is not entirely a one-man company is the intricate problem that the House of Lords has left us with following *Stone & Rolls*.

2. *The "Wrongfully-Incurred Unpayable Debt" Quagmire*

A similar but different quagmire is the one raised by the deepening insolvency situation. Is the auditor liable for the wrongfully-incurred unpayable debt that the company assumed? The accusation would be that if the auditor had picked up the material misstatements in the company's financial reporting, the company would have not taken further debt and liabilities would have been contained. This charge considers that creditors relied on the company's financial statements in order to extend credit to the company or – more simply – that the creditors had not extended credit if the company had been already liquidated. In the US the deepening insolvency theory seems to be in retreat both as a cause of action and a theory of damages.[187] This is understandable, since generally speaking in the US auditors are not liable to creditors unless special circumstances qualify their relationship[188] and managers have no corporate duty to creditors,[189] no duty to file for insolvency proceedings and therefore face no liability for prolonging, at least in good faith, the life of an insolvent company.[190] In such legal environment, directors are sufficiently well-protected, and so are their watchdogs, the external auditors.

3. *Italy's Specificity*

Once again, the situation is very different in Italy. Two elements make this possible.

a) The Insolvency Liquidator Right of Action

The Italian law states that the insolvency liquidator can sue either the internal auditors (Article 2407 C.c.) and the external auditors (Article 2409-sexies C.c., recalling Article 2407 C.c.)), on behalf of the company (Article 2393 C.c.) and the undistinguished class of the company's creditors as residual claimants [CLARIFY] (Article 2394 C.c.). No question therefore arises as to the final beneficiaries of the action. The defendant cannot claim that the liquidator's action is in favor of the creditors instead of the company, as the two entities coincides: the insolvency liquidator steps into the shoes of the company and its unsatisfied creditors as an undistinguished class vis-à-vis the management and their watchdogs the auditors.[191] It has never been noted, but the liquidator's action on behalf of the creditors as residual claimants is in fact a particular kind of class action, in a country where the UK and US approach would leave creditors without manageable means to aggregate their claims.[192]

---

[186] Note that the issue is completely different from a discussion on whether or not the auditor has a duty toward creditors as such. It is undisputed under the English and US systems that the answer is negative. The issue is exclusively whether the company is entitled to recover damages that would not have been suffered if the auditor did its job with care, when the proceeds go first to the benefit of creditors because there is a liquidation procedure to be applied. Note as well that a positive answer simply states that the action is vested with the insolvency liquidator.

[187] Cf. SABIN WILLETT, *The Shallows of Deepening Insolvency*, 60 Bus. Law. 549(2005). HEATON.

[188] Supra, ___ (foreseebility ecc.)

[189] See HENRY T.C. HU & JAY LAWRENCE WESTBROOK, *Abolition of the Corporate Duty to Creditors*, 107 Colum. L. Rev. 1321(2007).

[190] Supra, ____ (deepening insolvency theories)

[191] The insolvency liquidator cannot recover damages individually suffered by creditors who relied on the financial reporting. It can only recover damages suffered by the company, however the fact that the proceeds go to the benefit of the insolvent entity's creditors is precisely the purpose of his action.

[192] The Italian name shows this: "azione di massa."

b) The Role of "Recapitalize or Liquidate" Rule

The unsatisfied creditors are not seen as something different from the company because of the legal capital concept. The Italian system adopts a "recapitalize or liquidate" rule under which the directors have a duty to detect net assets unbalances and call a shareholder meeting when more than one third of the capital has been lost, or either liquidate or call shareholders to recapitalize when the whole capital has been lost.[193] It is assumed that creditors can observe this through the publication of the company's financial statements. If directors evade their duty by means of misstatements in the financial reporting, the insolvency liquidator steps in the shoes of company and its residual claimants (the creditors as an undistinguished class)[194] and brings a claim against the directors and the auditors asserting that, through the misreporting, the company prolonged its life and deepened its debt, when managers should have promptly initiated an insolvency procedure.[195]

c) Assessment

Italian substantive rules offer a very simplified and manageable legal environment. The rigid division that the Lords found in *Caparo* between benefit to shareholders and benefit to creditors and that became a conceptual nightmare in *Stone & Rolls* would simply considered to be fictitious under Italian law. In Italy, very differently from the US,[196] the bankruptcy trustee has the standing to pursue creditors' interests against directors and their watchdogs, as it is understood that the company's losses are also the creditors' once the company becomes insolvent (Article 2394 Civil code).[197]

In *Stone & Rolls* Lord Mance concludes his opinion recapping the main issue that has divided the House of Lords, namely

> "whether auditors, who should, in the performance of their contractual and tortious duties towards a company, have detected and (under the express terms of their engagement) then have reported to the appropriate authorities a scheme of fraud by top management rendering the company as a separate legal person increasingly insolvent, owe any enforceable duty towards the company to do this, so avoiding further loss to the company."[198]

There is no doubt whatsoever in Italy what the answer to this question should be. Auditors are also the guardians of legal capital and responsible for the prompt initiation by the company of the insolvency procedures aimed at protecting shareholders and above all creditors' interests. In Italy and other European countries the imputation defense is unknown owing also to the different system of insolvency rules and creditor protection rules traditionally embraced by Continental Europe.

---

[193] See LORENZO STANGHELLINI, Directors' Duties and the Optimal Timing of Insolvency: A Reassessment of the "Recapitalize or Liquidate" Rule (2009).

[194] Infra, ___

[195] Therefore, any damage rests with the managers and their guardians, the auditors. A manager that defended his case by asserting that the misstatements were aimed at getting some benefit to the company (for instance, the benefit pursued was capital at a lower cost) would imply that the company had not suffered any damage and that the damage, if any, was exclusively faced by the financing parties that relied on the misstatements.

[196] Where claims concerning wrongfully-incurred unpayable debt which are characterized as corporate injury claims can be considered an elusive vehicle to escape the rule established by the Supreme Court in *Caplin* that a bankruptcy trustee does not have standing to pursue creditors' claims that do not belong to the bankruptcy estate. See Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972).

[197]

[198] § 277.

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

A. *In IPOs, Auditors are Reputational Intermediaries Needed by the Issuer*

The idea embraced by *Ultramares* that auditors are in privity with the company and have no relationship with unknown third parties is not suited to the real workings of capital markets. When the company taps the financial markets, it is trying to convince a general class of investors to put money in the firm, in the form of equity, debt or any equity-like or bond-like hybrid as the case may be. Here the model becomes much more complex. The company is usually also promising to these investors that through listing it will create conditions for them to resell the financial instruments that they are going to underwrite or purchase. The usual asymmetric relationship between the company and its investors applies, but here it is amplified by a large collective action and intergenerational problem.

The collective action problem is that diffused investors are not singularly going to instruct an auditor to investigate the company's accounts. In an *Ultramares* situation, the company might expect the creditor to ask for a due diligence review by a specifically appointed auditor. In an IPO situation, there is no way anybody could expect the solicited, anonymous investors to instruct an auditor. Accordingly, it is clear that it is the company that has to instruct the auditor to the benefit of solicited investors. This situation has two consequences. First, the idea that the auditor is working for the shareholders as an antagonist controller of managers is out of place in a public offering scenario, as the managers are asking third parties for money on behalf of the company (the shareholders) and using the auditor as a reputational intermediary.[199] The corollary is that the director can even rely on the auditor with regards to the accounting data that the latter examines and certifies:[200] the auditor becomes somebody the director can trust when the company's accounts are considered. Since the audit can have an internal value at least as a director's defense, it can be confused with an internal audit.[201] The muddling of the auditor's role is rooted in the prospectus audit.

In an IPO scenario the privity concept collapses, because the investors are precisely the beneficiaries of the prospectus audit. The law considered this situation starting with the UK Companies Act 1929, mandating the company auditor's certification of the company's profit and loss statement for the last three years to be included in any prospectus used to sell shares.[202] This statute was the template of today's most famous example in this field, Section 11 of the Securities Exchange Act.[203] It has been recognized since its adoption that this rule was addressed to sorting out the 'privity problem' and its likes.[204]

[199] The *locus classicus* is RONALD J. GILSON & REINIER H. KRAAKMAN, *The Mechanisms Of Market Efficiency*, 70 Va. L. Rev. 549, 618-621 (1984). See also STEPHEN J. CHOI, *Market Lessons for Gatekeepers*, 92 Nw. U.L. Rev. 916, 924 (1998).who uses the term "certification intermediaries" instead.

[200] Supra, ____ (Directors Liability Act 1890)

[201] SEAN M. O'CONNOR, *Strengthening Auditor Independence by Reducing the Need for It: Reestablishing Audits as Control and Premium Signaling Mechanisms*, ssrn 1(2006).

[202]

[203] In this situation the auditor is no more an agent of the shareholders, but a professional rendering services to a client: O'CONNOR, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 824.

[204] O'Connor; see also the Uk Companies Act 1929: Id. at 769.new audit requirements for prospectus O'CONNOR, *Strengthening Auditor Independence by Reducing the Need for It: Reestablishing Audits as Control and Premium Signaling Mechanisms*.

B. Prospectus Auditing and Why the Floodgate Argument Is No Longer an Issue

1. US and UK

If this is true, why is exposition to unpredictable liability no longer an issue in this setting? Curious as it may seem, I have never found this obvious question posed in the literature. If the floodgate argument is reconceptualized as a problem of pricing risk, the answer can only lie in the mechanism followed by companies to tap the market, which puts auditors in a position to know *ex ante* how much capital the company is going to request and therefore to establish the risk involved by the audit activity.[205] Moreover, the registration requirements allow the auditor to read the prospectus and know how much money the company is going to ask the market for. The auditor is liable because he has given his consent to the mention of his name and work in the prospectus, accorded because the auditor knew what was going on, because he read the registration statement and knew how much money the client was seeking to raise.[206] Moreover, Sect. 11 (g) caps liability to the price at which the security was offered to the public. Liability is joint and several in this setting, contrary to secondary market liability, which in the US is proportionate.[207]

2. Italy

Under Italian law the role of the registration requirements in overcoming the floodgate argument is not visible, but this is simply because the floodgate argument is not a real issue there. Therefore, the Italian equivalent of Sect. 11 does not even mention that in order to be held liable the auditor must have given his consent to the insertion of the audit in the prospectus, and there is no cap to liability.[208]

3. Why Were Voluntary Liability Caps Not the Norm? Incomplete Audit Contract as an Efficient Strategy both for the Issuer and the Auditor

a) The Issue

If the company bargains on behalf of the investors, the company could negotiate specific terms in the audit contract and might for instance negotiate a liability cap with the auditors. However, in none of the countries considered in my research are the company and the auditors left free to negotiate the latter's liability regime. Here there is no agency problem at work, as the negotiation comes before the investment made by the investors, and investors could refuse to give money to a company that has negotiated unpalatable terms with its own auditor. Why is liability limitation not an issue in this scenario as well? One answer might be that securities law does not allow liability limitations, as the auditor role is perceived as a public role, whose liability cannot be subject to negotiation of any kind to keep the *in terrorem* effect that public policy deems necessary.[209]

---

[205] PAOLO GIUDICI, La responsabilità civile nel diritto dei mercati finanziari (Giuffrè. 2008).

[206] This is crystal clear under the Securities Act Section 11(a)(4), according to which persons liable include "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him." The same holds true under s90 and s150 of the UK Financial and Services Markets Act 2000.

[207] See infra, ___

[208] Article 94.8 CFSA.

[209] [quote]

b) Analysis of the Situation before Modern Securities Law

However, a modern analysis of the issue cannot entirely rely on these quick responses. If the law mandated prospectus audits that were already used in the market,[210] the question turns on to why voluntary prospectus audits did not contain any qualification with regards to auditor liability before the law stepped in and mandated them. The most likely answer is that explicit liability limitation is no option from a marketing perspective for an issuer who wants to solicit investors, because no issuer would dare to tap the market offering a prospectus audit in which the auditor does not put all his liability at stake. The engagement of an auditor is a bonding cost and the auditor's reputation and liability is what makes the bond credible.[211] Limited liability would reduce the bond's value and thereby the firm's capability to tap a competitive market where other firms offer the auditor's full liability. Since the privity doctrine made unclear whether auditors would be liable to investors, an equilibrium between the issuer and the auditor could be reached by not promising anything in favor of solicited investors, leaving the auditor's liability issue in a limbo.[212] In marketing activities the consortium could use the auditor as a reputational intermediary and a bonding mechanism, thereby offering evidence that the accounts could be relied on. In litigation, the auditor could deny liability invoking the privity doctrine. In this scenario the parties could rationally decide to leave the contract incomplete as to auditor liability, in order to leave the issue to the court. The reason was that in mass litigation the plaintiffs are dispersed, and singularly face incentives to litigate that are no match in comparison to the defendant's.[213] Accordingly, no significant litigation was to be expected; and in the rare cases where there was litigation, if the court denied the auditor's liability, the court was to be blamed, not the auditor.[214] In order to avoid these problems, the law stepped in and mandated prospectus audit liability.[215]

c) Assessment of the Current Situation

This reconstruction leaves open the question of why modern securities law seems to be so rigid in ruling prospectus liability. Why not allow liability limitation agreements now that the privity problem is no longer a disturbing element? It might be that in financial markets, standardization is required to reduce transaction costs, thereby making self-tailored liability unpalatable[216] due to the excessive demands on investors, who need to be able to make cross-comparisons among issuers.[217] However, it would also be possible to imagine a system of contracted limited liability, in which the issuer states in the prospectus if and how the auditors' liability is limited. The problem, standardization apart, is that this system would impact on the regime concerning liability to secondary market investors (if any), because it is

---

210 [expand]

211 Reputation alone is not enough. The scholars who relied entirely on reputation as a bonding instrument, such as GOLDBERG. did not consider the agency problems within the audit firm: see COFFEE JR., *Understanding Enron: "It's About the Gatekeepers, Stupid"*. They also did not consider that reputation is put at risk by litigation, and to have litigation you need liability: see Giudici

212 COFFEE JR., Gatekeepers: The Professions and Corporate Governance. At 113 observes, on the grounds of a different line of reasoning, that "some evidence suggests that … illusory bonding was prevalent in the U.S. market during the early 20th century".

213 Literature on class actions.

214 In the US before 1966 there was no significant litigation of the issue. The introduction of the class action reshaped this quiet scenario: MAHONEY, *The Development of Securities Law in the United States*, 333.

215 The apparently irrational scenario depicted in this paragraph, where investors leave the auditor liability issue open, is not particularly peculiar. The explosion of the litigation concerning the now disappeared auction rate securities (ARS) market is one of the many examples where investors did not 'stress test' contractual clauses. See Aline van Duyn & Joanna Chung, *Auction rate securities facing tough scrutiny*, Oct. 23, 2009, available at http://www.ft.com/cms/s/0/64bb7e50-bf6c-11de-a696-00144feab49a.html.

216 A proposal for self-tailored liability is advanced in CHOI, *Market Lessons*.

217 Cf. ZOHAR GOSHEN & GIDEON PARCHOMOVSKY, *The Essential Role of Securities Regulation*, 55 Duke L.J. 711(2006).

not imaginable to have a limited liability in the primary market and an unlimited liability in the secondary one, creating further complexities, which can be analyzed after having dealt with the fourth liability regime, namely liability to open market investors.

V. AUDITOR'S LIABILITY IN SECONDARY MARKETS (REGIME 4)

The differences among the US, the UK and Italy concerning liability towards the company are doctrinal. Common principles of contract liability are applied, even though with very different final results, which depend on the different role that the auditor is perceived to fulfill in corporate governance. The differences concerning prospectus liability are not particularly significant, at least at a general level, because the auditor's role in an IPO scenario is clear. On the topic of how to regulate auditor's liability to secondary market investors we find the most striking differences among the three legal systems.

1. UK

In the UK, negligent auditors are not liable towards secondary market investors, unless special circumstances exist. Outside prospectus liability, no statutory liability for inaccurate statements was in place before 2006. *Caparo* excludes common law negligence liability towards third parties, unless the defendant knows that some investors are going to rely on the statement.[218] The adoption of the Transparency Directive in 2004 forced the Government to introduce a statutory liability of issuers to investors for untrue or misleading statements in all periodic disclosures made to the market, through new Section 90A of the Financial Services and Markets Act 2000, introduced by the Companies Act 2006. Liability concerns issuers only, and exclusively for fraudulent misstatements.[219] An amendment of Section 90A following a review of Professor Paul Davies[220] is currently under discussion. Under its terms, liability will be extended, covering a broader range of disclosure. But the general framework will not be affected.[221]

2. US

The US scenario is the most famous, as it is the one where securities class actions are mainly used. Liability was originally implied under Rule 10b-5.[222] The PSRLA confirmed the existence of the civil right of action.[223] The plaintiff must show that the defendant acted with scienter in order to succeed. It is much discussed what scienter is. It is more than a negligence standard, and probably less than a desire to cause harm.[224] A special pleading rule requires plaintiffs to plead with particularity facts giving rise to a strong inference of fraud, therefore reducing the access to pre-trial discovery. With regards to auditors, probably the most significant specific protection against liability is the Supreme Court decision in *Central Bank* not to attach private aiding and abetting liability to the 10b-5 cause of action.[225] The decision was taken in 1994, at the apex of the debate concerning the need to reduce auditor liability.[226] The Court's reasoning is clearly influenced by this debate. The second specific

---

[218] See supra ___

[219] On this issue see PAUL DAVIES, Davies Review of Issuer Liability - Liability for misstatements to the market: A discussion paper by Professor Paul Davies QC 24-25 (2007).

[220] PAUL DAVIES, Davies Review of Issuer Liability: Final Report (2007).

[221] For a discussion see EILIS FERRAN, *Are US/Style Investor Suits Coming to the UK?*, 9 J. Corp. L. Stud. 315, 318-330 (2009).

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

[223] ?????

[224] For discussion see ____

[225] Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

[226] *See supra* ____

protection is offered by proportionate liability, introduced in 1995 with the PSLRA in substitution of joint and several liability.[227] The aggregate impact of these requirements has been a visible reduction of civil deterrence on the auditor, which is among the causes of the accounting crisis of 2001.[228]

3. Italy

Italy offers a completely different scenario. Italy does not differentiate between primary and secondary markets' liability.[229] Auditors are always liable towards investors in connection with financial misstatements that they might have identified, whether investors undersigned or bought newly issued shares or purchased shares in the secondary market. Negligence is the liability standard.[230] In the three main cases which were decided until now (*Freedomland, Parmalat, Fingem*),[231] no significant distinction was drawn between classes of investors by the court. The assumption is that investors damaged by lies, negligent and omissions ……

B. Law & Economics Analysis

The striking differences among the three legal systems asks for an analysis of the economic reasoning concerning this kind of liability.

1. In Favor of No Liability Whatsoever (Except Intentional Misrepresentation): the Pure "Wealth Transfer" Argument

The idea that secondary market investors should not have any action against the negligent or grossly negligent auditor is exposed as follows in the law and economics literature. The auditor's misstatement causes one investor to buy and another investor to sell. When the misstatement is corrected, the former investor discovers that he has purchased at a price higher than the one he would have chosen, whereas the latter investor discovers that he was lucky, because he sold the shares before the information about the true situation was disclosed. In this situation there is no social loss as there is no wealth destruction (equivalent to social loss). What you see is, allegedly, a mere transfer of wealth. If the auditor were asked to compensate the purchaser for the damages he suffered, the auditor should also be able to get the money back from the seller, who gained because of good luck and not because of some special merits. If the auditor cannot get the money back, the compensation is unrelated to the social cost (which is, by assumption, zero) and the liability system does not work properly: it over-deters wrongdoers, and auditors end up taking too much care.[232] From a "hypothetical bargain" approach,[233] investors cannot be interested in the company buying protection for them by asking the auditor to take liability (or the law to impose it), because they hold diversified portfolios and can with equal probabilities be on the buy side or on the sell side.[234] This is the core difference between primary market investors (who can only be on

---

[227]

[228] *See supra* ___

[229] The only significant difference might concern the burden of proof. For discussion see GIUDICI.

[230] It was proposed in the past to adopt a gross negligence standard, but [EXPAND]

[231]

[232] BISHOP.

[233] See DAVID CHARNY, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 Mich. L. Rev. 1815(1991). IAN AYRES & ROBERT GERTNER, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87, 89-90 (1989). Ayres and Gertner use the expression "would have wanted" theory.

[234] GIUSEPPE DARI MATTIACCI & HANS-BERND SCHÄFER, *The Core of Pure Economic Loss*, 27 International Review of Law and Economics 1(2007).

the buy side, and want protection) and secondary market investors (who do not care, because they do not know where they will be).

2. *In Favor of Liability*

a) The Case of Undiversified Investors

If the assumption of purely diversified portfolios is relaxed, things change. Undiversified investors can still equally be on one side or the other, but their risk increases.[235] Risk-adverse investors do not want to take all this risk on their shoulders and demand protection. Therefore, companies need to buy protection in the form of auditor's liability. Indeed, this is what we see in large block transactions, where the buyer usually asks for a due diligence review in which an auditor is involved and a company's balance sheet at the time of the transaction is drafted.[236] In this scenario some form of liability is needed.

b) Taking into Consideration the Link between Primary and Secondary Markets

Apart from the portfolio diversification issue, the wealth transfer payment argument does not consider the links between primary and secondary markets. Let me go back to the primary market. The assumption is that the company wants to reassure the investor and therefore finds an auditor who acts as a gatekeeper. If the primary market investor is potentially interested in reselling the shares – and this is certainly so if the shares are sold in the course of an initial public offering aimed at listing the company, for listing aims at creating liquidity[237] – he may want the company to employ an auditor to the benefit of potential buyers also in the future, if and when he decides to sell the shares. Moreover, the first investor will want to be sure that the auditor's responsibilities to third parties (if any) are fixed at least until the moment he enters the secondary market to sell his shares. Needless to say, the second investor might wish the same, and so on, as nobody wants to buy a financial instrument that will negatively modify its rights and entitlements when in his hands.

Is this wish reality in modern financial markets? The fact that in private transactions concerning shares purchases buyers ask for an audit of the company's records in order to ascertain the firm's value might also be related to this wish, independently from the level of diversification. More important, empirical studies show that, in secondary markets, disclosure of information and, in particular, earning announcements and financial data boosts trade volumes.[238] Disclosure generates liquidity.[239] Accordingly, it is reasonable to assume that an

[235] [Explain in financial terms]

[236] Many Italian cases concern this scenario: ___

[237] *See infra* ___

[238] The mechanism is investigated in the model proposed by OLIVER KIM & ROBERT E. VERRECCHIA, *Pre-announcement and event-period private information*, 24 J. Acc. Econ. 395(1997). and empirically tested, for instance, by OLE-KRISTIAN HOPE, et al., *Geographic earnings disclosure and trading volume*, 28 Journal of Accounting and Public Policy 167(2009).

[239] ROBERT E. VERRECCHIA, *Essays on Disclosure*, 32 J. Acct. & Econ. 97(2001);LUZ HAIL & CHRISTIAN LEUZ, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 Journal of Accounting Research 485(2006). (firms from countries with more extensive disclosure requirements, stronger securities regulation, and stricter enforcement mechanisms have a significantly lower cost of capital). WARREN BAILEY, et al., *The economic consequences of increased disclosure: Evidence from international cross-listings*, 81 J. Fin. Econ. 175(2006). (absolute return and volume reactions to earnings announcements typically increase significantly once a company cross-lists in the U.S., supporting the hypothesis that it is the individual firm's disclosure environment to explain the increase). RICHARD LAMBERT, et al., *Accounting Information, Disclosure, and the Cost of Capital*, 45 Journal of Accounting Research 385(2007). the quality of accounting information can influence the cost of capital. R.K. ATIASE & L.S. BAMBER, *Trading volume reactions to annual accounting earnings announcements*, 17 J. Acc. Econ. (1994). See more in general CHRISTIAN LEUZ & PETER WYSOCKI, *Economic Consequences of Financial Reporting and Disclosure*

investor in the primary market who is potentially interested to sell his shares in the secondary market would require a future audit and some form of reliable assurance that the audit performed will be accurate as this will offer a boosted platform for liquidating his investment.[240] This assurance concerns liquidity, and reduces the "wedge" between demand and offer of securities.[241] Add to this that negligent audit will influence the prices of future primary market emissions of the same security,[242] as well as the market for corporate control.[243] Finally, consider that the value inflation of a security traded on secondary markets affects the alternative investment offered on the primary market and thereby project choice in the society,[244] and it appears that some form of liability to secondary market investors is needed to impose socially desirable care on the auditor. On the ground of considerations partially similar to the ones here developed a prominent US academic has pointed out that "disclosure has substantially equal social value whether or not the firm is selling equity at the time"[245] and therefore that "civil liability should be structured to give corporate decisionmakers equally strong incentives for disclosure regulation whether or not the firm is publicly offering equity at the time".[246] However, it is clear that the issuer's private incentives to mislead investors can be more pronounced in primary markets that in secondary ones.

3. What Kind of Liability?

Contractual liability is unachievable here, because the issuer needs to negotiate a liability regime with the auditor that lasts forever and that can never be renegotiated to the benefit of any secondary market investors. This is the classic scenario where tort liability has to step in.[247]

Unsurprisingly, economic analysis of law has focused its attention on the US federal law, discussing, amongst other things, why there is a difference of liability regime between the primary market (Section 11 Securities Act) and the secondary market (Rule 10b-5). The recurrent answer is that, at least theoretically, in the former the company benefits from its misstatements, by gaining at the expense of the unaware investor, whereas in the latter the company does not get any money and therefore faces less powerful incentives to misstate information. Accordingly it is argued that, in terms of the need for deterrence, the second situation can be addressed differently, taking also into consideration that, because of the class action mechanism, there is a serious risk of over-deterrence.[248] Scienter is therefore accepted as the liability standard, as it limits claims to the most egregious cases of gross negligence.[249] In Germany these arguments have been very successful as well, as auditor liability to secondary market investors is capped and the wealth-transfer argument provides reasons in

Regulation: A Review and Suggestions for Future Research. (survey of the theoretical and empirical literature on the economic consequences of financial reporting and disclosure regulation).

[240] "Whichever reason motivates a potential buyer, if she anticipates a low level of liquidity in the secondary market at whatever time she might wish to sell in the future, the share she is considering purchasing is worth less to her. Her anticipation of a high bid/ask spread at the time that she sells means that she anticipates a lower sale price. As a result, she will not be willing to pay as much to purchase the shares today": FOX, 267.

[241] Id. at 267.

[242] BRUCE CHAPMAN, *Limited Auditors' Liability: Economic Analysis and the Theory of Tort Law*, 20 C.B.L.J. 180, 196-197 (1992).

[243] Id. at 196-197.

[244] FOX.

[245] Id. at 260-264.

[246] Id. at 269.

[247]

[248] DONALD C. LANGEVOORT, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639(1996).

[249]

favor of the cap.[250] As seen, in the UK liability concerns exclusively willful acts. Negligence and gross negligence face no civil liability.

Presumably in countries like Italy the absence of any powerful favorable plaintiff's weaponry and thereby of any perceived over-deterrence of private enforcement explains why there is no differentiation between primary and secondary market liability, why negligence is the legal standard and why the issue is basically not covered by the legal literature.

4. *Proportionate versus Joint and Several Liability*

A rich part of the US debate pre-1995 concerned the joint and several liability system that channeled actions against companies and managers towards auditors, the "deep-pockets" that plaintiff could easily coerce – so the argument went – to settle. Auditors obtained proportionate liability [CLARIFY] through the PSLRA with reference to investors' suits.[251] Once again, the legislative amendment was considered more as a measure to reduce the alleged over-enforcement of securities class actions than a move based on a clearly modeled theory of joint tortfeasors liability. In a literature that easily argues in favor of reputational incentives and market contracting, no word is given to explain how the right to contribution works in this context and why it has not been useful to make auditors active controllers of primary violators' wealth, considering that joint and several liability with contribution shares determined by fault is aimed at activating reciprocal controls over potential joint tortfeasors.[252]

5. *Limiting Liability through Company Law*

As a defensive measure against allegedly excessive exposure to liability risk following the S&L litigation explosion, lawyers and auditors in the US lobbied states' legislatures to be allowed to use the limited liability partnership. Texas started in 1991 and in a few years other states followed in mass.[253] Some commentators have argued that this move, by reducing partners' incentives to monitor, is one of the reasons why audits became less reliable and the accounting crises exploded.[254] Big audit firms' reputation should act as a counterbalancing force to reduced peers' monitoring.

---

[250] German doctrine

[251]

[252] I have not found any article addressing this issue in the auditor litigation literature, whether in law reviews or in accounting reviews. On some of the conceptual problems raised by joint and several liability see LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Sharing Damages Among Multiple Tortfeasors* 98 Yale L.J. 831(1989);LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Apportioning Damages among Potentially Insolvent Actors*, 19 J. Leg. Stud. 617(1990);LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Settlement Under Joint and Several Liability*, 68 N.Y.U. L. Rev. 427(1993);LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Multidefendant Settlements Under Joint and Several Liability:The Problem of Insolvency*, 23 J. Leg. Stud. 517(1994);LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Multidefendant Settlements: The Impact of Joint and Several Liability*, 23 J. Leg. Stud. 41(1994);JOHN J. DONOHUE, *The Effect of Joint and several Liability on the Settlemente Rate. Matematicl Symmetries and Metaissues about Rational Liteigant Behavior. Comment on Kornhauser and Revesz*, 23 J. Legal Studies 543(1994);LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Evaluating the Effects of Alternative Superfund Liability Rules*, *in* Analyzing Superfund: Economics, Science, and Law (Richard L. Revesz & R. Stewart eds., 1995);LEWIS A. KORNHAUSER & RICHARD L. REVESZ, Joint and Several Liability § 2 (Peter Newman ed., 1998);LEWIS A. KORNHAUSER & RICHARD L. REVESZ, Joint Tortfeasors (Boudewijn Bouckaert & Gerrit De Geest eds., Edward Elgar 2000).

[253] ROBERT W. HAMILTON, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. Colo. L. Rev. 1065(1995). The main argument was that, since audit firms had reached a huge dimension and complexity, it is was not feasible any more for partners to monitor each other.

[254] JONATHAN R. MACEY & HILLARY A. SALE, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 Vill. L. Rev. 1167(2003).

The Parmalat case offers mixed evidence. Apart from the US final decision on the subject of their civil liability toward the company,[255] it is clear that the Italian entities of Grant Thornton's and Deloitte Touche's networks did not operate with due care.[256] However, apparently the reputation's disruption of the local entities has not significantly affected the US headquarters, showing that local shields can be abandoned with no big harm.[257] Should this case be not a single event but the evidence of a pattern, it would be clear that the adoption of the limited liability format can be, at least outside the largest financial markets [ITALY IS SMALL, CLARIFY], a strong instrument to shield auditors from liability.

By contrast, Judge Kaplan's decision in *In Re Parmalat Securities Litigation* to consider existent a principal-agent relationship between the auditors' headquarters in America and their Italian entities, rejecting the corporate shield defense raised by the US entities to escape the investors' securities class action, could affect the brand reputation worldwide, even though limited liability partnership remains an available instrument against catastrophic liability.

VI. PROBLEMS CREATED BY THE OVERLAP

A. Double Recovery (Overlap of Regimes 1 and Regimes 3 or 4)

If recovery is granted to investors (either those on primary or secondary markets), a hidden problem emerges: double recovery, in case there is an action both by the company and by the investors. The double recovery issue arises in cases where the investors who have purchased the corporate securities claims damages for the difference between what they paid and the true market value of the securities, and this difference is wholly or in part due to assets looted by managers or assets burned by the firm without any previous reported information. In these cases, both the investors and the company could claim damages. However, the damages could be related to the same event. Consider this example. The company possesses a cash reserve that managers or controlling shareholders have siphoned off. The financial statements mention the reserve among the company's assets. Let me assume that they represent the 50 per cent of the company's equity. The company issues new shares. When the looting is discovered, the company's shares halves their value. The company can claim the money lost, whereas investors can claim the excessive price paid to buy the newly issued shares. If the company recovers the money and the new shareholders have not sold their shares, any damage is restored. If investors have disposed of their shares, they might be entitled to claim damages independently from what the company gets back. If investors recovers their "investment" damage and the company its "asset" damage, there is double recovery.

Double recovery is an issue under US law, but has never been a significant one under Italian and, clearly, under English law. [CLARIFY]

1. CENCO

The prototypical case of a double-recovery scenario is offered by *Cenco*.[258] Cenco Incorporated management had orchestrated in a massive fraud. The fraud involved the inflating of inventories, which enlarged the apparent value of the company. The inflated

---

[255] Supra, ___

[256] [sentenze italiane di condanna di Bianchi e Penco; provv. Consob; decisione Trib Milano]

[257] See FERRARINI & GIUDICI, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case* (

[258] Cenco Incorporated v. Seidman & Seidman, 686 F.2d 449; 1982 U.S. App. LEXIS 20664; Fed. Sec. L. Rep. (CCH) P98,615 (7th Cir. 1982).

shares were used to buy other companies.[259] Cenco was also able to borrow funds at cheaper rates and to present inflated claims for inventory lost or destroyed to its insurers.[260] Investors who had bought Cenco shares at inflated prices or who sold or held the shares at a loss after the fraud's discovery sued the company and the auditors and got a settlement. Cenco sued the auditors on the assumption that managers had not been properly monitored. In a famous opinion, Judge Posner dismissed Cenco's claim also on the grounds of the perverse double-recovery effect that a judgment in favor of the company would have granted shareholders who had kept the shares and had received money from the settlement.[261] It is to be questioned whether the court would have held the same position if this argument had been the only ground for the dismissal of Cenco's claim.

2. Analysis

Double-recovery is a problem under any civil law, because it goes against the compensation principle. It is particularly problematical in countries that have no US-type punitive damages and therefore are strict on the issue of not allowing the plaintiff to get more than his actual damages. However, double recovery is unavoidable once an auditor's liability to investors is admitted (as it is in all the three countries considered by me), and more so if also auditor's liability for misstatements to secondary market investors is acknowledged (as it is in Italy and, under strong constraints, in the US). The only solution to avoid double recovery would be to deny the investors or the company's claim, even though it is clear that the latter is the natural claim against the auditor as the law of all countries recognizes (even though the US *in pari delicto defense* creates a sizeable barrier to companies' claims). An alternative would be to use procedural mechanisms that oblige both the company and the investors to have their cases discussed before the same court; additionally, the court may dismiss the claims of investors who still hold financial instruments of the company, for the part of their damages that will be indirectly restored through payment from the auditor to the company. The latter proposal is not to be taken seriously in countries, like Italy and the UK, where the issue is purely theoretical, because enforcement of investors' claims is weak or non-existent. In the US, in contrast, the problem is visible and unaddressed in a systemic way.[262] However, in the US the rigidity of the compensation principle is minor because of punitive damages and the likes.[263]

A further possibility would be to force investors who want to recover damages to sell at their peril, meaning that only the company can sue the auditor and that their position can be restored only through the company's action against managers and auditors.[264] This would

---

[259]

[260] As Posner remarks, the managers orchestrating the fraud were not stealing from the company; they were aggrandizing both the company and themselves at the expense of third-parties. This is the traditional US perspective. *See supra* ___

[261] This is the significant part of the opinion: "The people who bought during the fraud period and either sold at a loss or continue to hold at a loss are the plaintiffs in the recently settled class action in which both Cenco and Seidman were defendants. Seidman has already paid $ 3.5 million to them. Those who continue to own stock in Cenco (as distinct from those who sold at a loss) would receive additional compensation if Cenco prevailed in this action against Seidman. This is not to say they would be overcompensated; but it seems odd that the same shareholders should be able to recover damages from Seidman twice for the same wrong -- once directly and once, in this suit, indirectly. Finally, the shareholders who bought after the fraud was unmasked lost nothing. The unmasking of the fraud caused the price of Cenco's stock to be bid down to reflect not only the true value of its inventories but also any anticipated injury to the company as a result of the fraud.

Because of shareholder turnover, there is always a potential mismatch between the recovery of damages by a corporation and the compensation of the shareholders actually injured by the wrong for which the damages were awarded. It is simply a more dramatic mismatch in this case than usual" (at 455).

[262] To the best of my knowledge, the double recovery issue has attracted no research attention.

[263] Treble damages in antitrust context; _____

[264] An Italian legal writer made this proposal at the beginning of the previous century: Vivante

amount to a revolution in the private law systems of all the countries that acknowledge the action of investors against the managers, giving value to the choice of those countries, like France, that do not permit investors to sue managers, but the company, which is therefore immediately forced to sue the auditor and the managers.

B. Regimes 3 and 4 Overlap Problems

1. Tracing

Any legal regime that differentiates between purchasers who undersigned or bought in the primary market and purchasers in the secondary market must distinguish between different classes of investors in situations where such distinctions may be by no means easy to make. This is the difficult task that US courts have to manage ("tracing requirement") and that, by contrast, Italian courts can ignore.[265]

2. Liability Cap Problems

I have mentioned in previous pages the relevance of the link between primary and secondary markets. I have showed that, with regards to primary market investors, liability caps are conceivable, but there is the problem of standardization and, in any event, the relationship with secondary market liability has to be more precisely assessed. With regards to secondary market investors, liability (if any) must be in the form of tort liability. It is necessary, even with perfectly diversified investors, because information creates liquidity. In the light of this, it appears that liability caps in the context of IPOs would be greatly affected by secondary market liability, as the former would be flexible whereas the latter can only be general and therefore fixed (being tort liability). It would be rather curious if, to offer an example, an issuer could arrange for its auditor's liability to be capped at 5 million Euro in an IPO and the auditor's liability to investors who buy the shares in the secondary market were also not limited in some way. Investors would have incentives to buy the securities in the secondary market and no rational investor would underwrite the shares in the primary market. Accordingly, limitation caps in primary markets are conditioned by limitation caps in secondary markets.

VII. CONCLUSION

The analysis shows that the auditor liability case is much more difficult than the reader of the economic literature might imagine. At least three different liability regimes come to the surface. A fourth is present at least in Italy (liability towards company's creditors). They are strictly interconnected. Each one presents its own peculiarities, which cannot be considered in a vacuum, but must be assessed considering the whole system of rules governing auditor liability in each country. If bankruptcy law, corporate governance, capital markets law, civil procedure peculiarities concerning each single country are added to the picture, any idea that the issue can be easily and uniformly managed vanishes.

If one considers the three main regimes (liability to the company, to solicited primary market investors, to secondary market investors), a case for mandatory limitation of liability can be held in the last regime only. UK do not have any liability toward secondary market investors, unless willful conduct is proven. This is 'real life' hard evidence that negligence liability in this field is not essential. In the US liability is *de facto* limited as well by the *scienter* requirement, proportionate liability, and the non application of common law tort

[265] HILLARY A. SALE, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 Wash. L. Rev. 429(2000).

rules concerning aiding and abetting. Other countries not considered in this article adopt liability caps in this area: Germany is the most egregious example. However, the reduction or abolition of liability towards secondary market investors has to consider that information, especially reliable information concerning financial statements, creates liquidity. For countries with capital market liquidity problems the introduction of liability caps could be highly detrimental, especially when the audit network perceives that its global brand's reputation is not at risk. Moreover, this move would create complexity in the liability system, as investors who are in a similar position would be treated differently whether they have undersigned or purchased newly issued financial instruments from the company (the consortium) or from other market participants. This complexity could create negative incentives to operate in the secondary market on the eve of a new issuance of shares. Finally, fixed caps in secondary market liability are a precondition to negotiated caps in public offerings' settings.

Mandatory limitation of auditor liability to the company would go at the core of the auditing function and require an answer to the question of why mandatory audit are required. There are no reasoned arguments in the economic literature and in the law and economics literature in favor of the introduction of mandatory caps to this form of contractual liability. Absent any strong scientific support, any proposal that goes in this direction must be fiercely rebutted. Accordingly, the EC Commission recommendation on this point is flawed and must be ignored.

A different assessment concerns contractually negotiated agreements to expand or restrict auditor liability to the company. In the US auditor liability to the company is *de facto* limited through the imputation defense and the rebuttal of the innocent insider exception. The case-law, however, works as a default restriction to liability, since the company remains free to negotiate contractual terms under which the auditor explicitly renounces to *in pari delicto* defenses, at least in presence of an innocent insider to which the management misconduct can be reported. In the UK it is unclear at the moment how the US imputation defense should really work, as *Stone & Rolls* have left many questions unanswered. Nevertheless, liability caps can be accorded by the shareholders meeting. The UK approach is coherent in a contractual framework and can work, at least as far as there are no significant intergenerational problems among shareholders. Needless to say, shareholders should not find easy ways to circumvent the company's agreement by suing the auditor as market investors, otherwise the cap on liability to the company can lead to an increase of direct claims of investors against the auditor and therefore propose the double-recovery issue mentioned in previous paragraph (even though reduced by the cap). Only countries where the intergenerational problem can be significant and hurdles to direct investors' claims are not easy to establish may have an interest in keeping a non negotiable (mandatory) regime of audit liability to the company.

Finally, liability to primary market investors. Also in this area there are no economic arguments in favor of a mandatory cap to liability. Under US Section 11 there is a liability limitation, which is not particularly significant. In any event, issuers could ask auditor to renounce to this limitation, therefore the US is mandatory in one direction only. Caps do not exist in the UK and in Italy. However, apart from the needs of standardized financial instruments by market investors, no further argument could be advanced against tailored-made liability regimes where the auditor reduces its liability exposures up to a certain limit. Needless to say, this limit must be coherent with the one eventually adopted with reference to liability towards secondary market investors, otherwise an incentive not to purchase new shares would be created. But the issuing company has good incentives to avoid any distortion.

This multi-layered environment creates problems. The coordination between any cap to liability towards primary market investors and secondary markets investors is a first problem. Tracing is a second problem, when the law differentiates primary and secondary market liability. Double recovery is a third problem, when managers have at the same time damaged both investors and the company.

In one of the three legal environments considered by this article, Italy, there is also a fourth liability regime: liability towards creditors. This liability regime is rooted in history (outside auditors replaced inside auditors), corporate governance, rules on legal capital protection, the possibility of creditor claims' aggregation through the insolvency liquidator's right of action on behalf of both the company and the creditors (in a country where otherwise creditors would not have any form of collective action). In a country with a low level of private enforcement, this liability rule can simplify some of the issues raised by auditor multi-layered regime, especially with regards to the right of the insolvency liquidator to recover money that merely transits through the company and goes to the creditors of the insolvent firm.

The fear of an imminent catastrophe in the audit field should only induce countries to fine-tune liability to secondary market investors and, eventually, to accept contractually negotiated and fully transparent agreements between the company and the auditor, aimed at modifying the default liability regime towards the company and primary markets investors. No argument except capture by the auditor lobby can sustain a mandatory fixed limited cap in regimes 1 (liability to the company) and 3 (liability to primary market investors). If a catastrophic liability draws into the abyss another audit network, the only solution would be to eliminate mandatory audit and leave companies, shareholders, investors to look for alternative solutions or smaller auditors, with whom they can negotiate liability terms from scrap. This would offer a new market driven answer to the question posed in the title of this article.

JOHN C. COFFEE JR., Gatekeepers: The Professions and Corporate Governance (Oxford Univ. Press. 2006).

JOHN C. COFFEE JR., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 Bus. Law. 1403(2002).

ROY CHANDLER & JOHN RICHARD EDWARDS, *Recurring Issues in Auditing: Back to the Future?*, 9 Accounting, Auditing & Accountability Journal 4(1996).

ERIC L. TALLEY, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 Colum. L. Rev. 1641(2006).

LAWRENCE A. CUNNINGHAM, *Too Big To Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels*, 106 Colum. L. Rev. 1698(2006).

JOHN C. COFFEE JR., *Reforming the Securities Class Action: An Essay On Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534(2006).

AMANDA M. ROSE, *Reforming Securities Litigation Reform: Restructuring The Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 Colum. L. Rev. 1301(2008).

Study on the Economic Impact of Auditors' Liability Regimes (MARKT/2005/24/F): Final Report To EC-DG Internal Market and Services. pt. 1-332 (2006).

CAROLINE M. BRADLEY, *Rhetoric and the Regulation of the Global Financial Markets in a Time of Crisis: The Regulation of Credit Ratings*, Transnational Law & Contemporary Problems, Forthcoming (2009).

FRANK PARTNOY, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 Wash. U.L.Q. 619(1999).
FRANK PARTNOY, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, Council of Institutional Investors, April 2009 (2009).
JOHN P. HUNT, *Credit Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, SSRN eLibrary (2008).
DOUGLAS W. HAWES, *Stockholder Appointment of Independent Auditors: A Proposal*, 74 Colum. L. Rev. 1(1974).
T.J. FIFLIS, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 Vand. L. Rev. 31(1975).
NEWTON N. MINOW, *Accountants' Liability and the Litigation Explosion*, Journal of Accountancy 70(1984).
PAUL G. MAHONEY, *The Development of Securities Law in the United States*, 47 J. Acc. Research 325(2009).
VICTOR P. GOLDBERG, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. Legal Stud. 295(1988).
V. G. NARAYANAN, *An Analysis of Auditor Liability Rules*, 32 Journal of Accounting Research (1994).
FRANK GIGLER, *An Analysis of Auditor Liability Rules: Discussion*, 32 Journal of Accounting Research (1994).
JOHN C. COFFEE JR., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 Cornell L. Rev. 269(2004).
INDER K. KHURANA & K K. RAMAN, *Litigation Risk and the Financial Reporting Credibility of Big 4 Versus Non-Big 4 Audits: Evidence from Anglo-American Countries*, 79 Acct. Rev. 473(2004).
CLIVE S. LENNOX, *Audit quality and auditor size: An evaluation of reputation and deep pockets hypotheses*, 26 Journal of Business Finance and Accounting 779(1999).
RAMGOPAL VENKATARAMAN & JOSEPH P. WEBER, *Litigation Risk, Audit Quality, and Audit Fees: Evidence from Initial Public Offerings* 83 Accounting Review 1315(2008).
HO-YOUNG LEE, et al., *The Effect of the Private Securities Litigation Reform Act of 1995 on the Cost of Equity Capital* 48 Quarterly Journal of Finance and Accounting 85(2009).
JOCHEN BIGUS, *Auditors' Liability with Overcompensation and Reputation Losses*, ??? ??? (2009).
RONALD A. DYE, *Auditing Standards, Legal Liability, and Auditor Wealth*, 101 J. Pol. Econ. 887(1993).
RACHEL SCHWARTZ, *Auditors' Liability, Vague Due Care, and Auditing Standards*, 11 Review of Quantitative Finance and Accounting 183(1998).
RALF EWERT, *Auditor Liability and the Precision of Auditing Standards*, 155 J. Inst. & Th. Econ. 181(1999).
RONALD A. DYE, *Incorporation and the Audit Market*, 19 Journal of Accounting and Economics 75(1995).
HANS-BERND SCHÄFER, *Efficient Third Party Liability of Auditors in Tort Law and in Contract Law*, Supr. Ct. Econ. Rev. 181(2004).
JAN S. BLAISING, *Note, Are the Accountants Accountable? Auditor Liability in the Savings and Loan Crisis*, 25 Ind. L. Rev. 475(1991).
ROBERT TILLMAN & HENRY N. PONTELL, *Organizations and Fraud in the Savings and Loan Industry*, 73 Social Forces (1994).
CALAVITA, et al., *The Savings and Loan Debacle, Financial Crime, and the State*, 23 Annual Review of Sociology 19(1997).

GEORGE A. AKERLOF & PAUL M. ROMER, *Looting: The Economic Underworld of Bankruptcy for Profit*, 2 Brookings Papers on Economic Activity 1(1993).
MERLE ERICKSON, et al., *Why Do Audits Fail? Evidence from Lincoln Savings and Loan,* Journal of Accounting Research 165(2000).
CLAIRE KAMM LATHAM & MARK LINVILLE, *A Review of the Literature in Audit Litigation*, 17 J. Acct. Literature 175(1998).
JAMIE PRATT & JAMES D. STICE, *The Effects of Client Characteristics on Auditor Litigation Risk Judgments, Required Audit Evidence, and Recommended Audit Fees*, 69 Accounting Review (1994).
KENT ST PIERRE & JAMES A. ANDERSON, *An Analysis of the Factors Associated with Lawsuits Against Public Accountants*, 59 Accounting Review (1984).
ZOE-VONNA PALMROSE, *Litigation and Independent Auditors: The Role of Business Failures and Management Fraud.*, 87 Auditing: A Journal of Practice and Theory 909(1987).
THOMAS LYS & ROSS L. WATTS, *Lawsuits against Auditors*, 32 Journal of Accounting Research (1994).
ZOE-VONNA PALMROSE, *An Analysis of Auditor Litigation and Audit Service Quality*, 63 Accounting Review (1988).
JAGAN KRISHNAN & JAYANTHI KRISHNAN, *Litigation Risk and Auditor Resignations*, 72 Accounting Review (1997).
ROSS D. FUERMAN, *Naming Auditor Defendants in Securities Class Actions*, 7 Journal of Legal Economics (1997).
JOSEPH V. CARCELLO & ZOE-VONNA PALMROSE, *Auditor litigation and modified reporting on Bankrupt clients*, 32 J. Accounting Res. 1(1994).
JANET COOPER ALEXANDER, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 1487(1991).
JOEL SELIGMAN, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority"* 108 Harv. L. Rev. 438(1994).
ZOE-VONNA PALMROSE, *Trials of Legal Disputes Involving Independent Auditors: Some Empirical Evidence*, 29 Journal of Accounting Research (1991).
MICHAEL L. ETTREDGE, *Trials of Legal Disputes Involving Independent Auditors: Some Empirical Evidence: Discussion*, 29 Journal of Accounting Research (1991).
ZOE-VONNA PALMROSE, *Audit Litigation Research: Do the Merits Matter? An Assessment and Directions for Future Research*, 16 Journal of Accounting and Public Policy 355(1997).
DAVID L. GILBERTSON & STEVEN D. AVILA, *The Plaintiffs' Decision to Sue Auditors in Securities Litigation: Private Enforcement or Opportunism?*, 24 Iowa J. Corp. L. 681(1999).
JOEL SELIGMAN, *Rethinking Private Securities Regulation*, 73 U. Cin. L. Rev. 95(2004).
JAMES D. COX, *Making Securities Class Actions Virtuous*, 39 Ariz. L. Rev. 497(1997).
MARSHALL A. GEIGERA, et al., *Auditor decision-making in different litigation environments: The Private Securities Litigation Reform Act, audit reports and audit firm size* Journal of Accounting and Public Policy 332(2006).
SRIKANT DATAR & MICHAEL ALLES, *The Formation and Role of Reputation and Litigation in the Auditor-Manager Relationship*, 14 Journal of Accounting, Auditing and Finance (1999).
STEPHEN A. HILLEGEIST, *Financial Reporting and Auditing under Alternative Damage Apportionment Rules*, 74 Accounting Review (1999).
HO-YOUNG; LEE, et al., *The Effect of the Private Securities Litigation Reform Act of 1995 on the Cost of Equity Capital*, 48 Quarterly Journal of Finance and Accounting 85(2009).
D. KATHERINE SPIESS & PAULA A. TKAC, *The Private Securities Litigation Reform Act of 1995: The Stock Market Casts Its Vote*, 18 Managerial and Decision Economics (1997).

MARILYN F. JOHNSON, et al., *Shareholder Wealth Effects of the Private Securities Litigation Reform Act of 1995*, 5 Review of Accounting Studies (2000).
ASHIQ ALI & SANJAY KALLAPUR, *Securities Price Consequences of the Private Securities Litigation Reform Act of 1995 and Related Events*, 76 Acct. Rev. 431(2001).
JEFF P. BOONE, et al., *Litigation Reform, Accounting Discretion, and the Cost of Equity*, Journal of Contemporary Accounting and Economics, 2009 (2009).
STEPHEN J. CHOI, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J. L. Econ. & Org. 598(2006).
MICHAEL A PERINO, *Did The Private Securities Litigation Reform Act Work?*, U. Ill. L. Rev. 913(2003).
ZOE-VONNA PALMROSE & SUSAN SCHOLZ, *Restated Financial Statements and Auditor Litigation*, SSRN eLibrary (2000).
WILLIAM G. HENINGER, *The Association between Auditor Litigation and Abnormal Accruals*, 76 Acct. Rev. 111(2001).
PAUL D. NEWMAN, et al., *The Role of Auditing in Investor Protection*, 80 Acct. Rev. 289(2005).
CHEE KEUNG KEVIN LAM & YAW M. MENSAH, *Auditors' Decision-Making Under Going-Concern Uncertainties in Low Litigation-Risk Environments: Evidence from Hong Kong*, 25 Journal of Accounting and Public Policy 706(2006).
JOSEPH P. WEBER, et al., *Does Auditor Reputation Matter? The Case of KPMG Germany and ComROAD AG*, 46 Journal of Accounting Research 941(2008).
RAFAEL LA PORTA, et al., *What Works in Securities Laws?*, 61 J. Fin. 1(2006).
HOWELL E. JACKSON & MARK J. ROE, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. Fin. Econ. 207(2009).
RAFAEL LA PORTA, et al., *Legal Determinants of External Finance*, 52 J. Fin. 1131(1997).
ANDREI SHLEIFER & ROBERT W. VISHNY, *A Survey of Corporate Governance*, 52 J. Fin. 737(1997).
RAFAEL LA PORTA, et al., *Law and Finance*, 106 J. Pol. Econ. 1113(1998).
RAFAEL LA PORTA, et al., *Corporate Ownership Around the World*, 54 The Journal Of Finance 471(1999).
RAFAEL LA PORTA, et al., *Investor Protection and Corporate Governance*, 58 J. Fin. Econ. 3(2000).
SIMON JOHNSON, et al., *Tunneling*, 90 Am. Econ. Rev. 22(2000).
ANDREI SHLEIFER & DANIEL WOLFENZON, *Investor Protection and Equity Markets*, 66 J. Fin. Econ. 3(2002).
SIMEON DJANKOV, et al., *The Law and Economics of Self-Dealing*, (2006).
JOHN ARMOUR, et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, SSRN eLibrary (2008).
SANJAI BHAGAT, et al., *The Promise and Peril of Corporate Governance Indices*, 108 Colum. L. Rev. 1803(2008).
LUCIAN A. BEBCHUK & ASSAF HAMDANI, *The Elusive Quest for Global Governance Standards*, 157 U. Pa. L. Rev. 1263(2009).
SOPHIE COOLS, *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers* 30 Delaware Journal of Corporate Law 697(2005).
JOSEPH F. BRAZEL, et al., *Investor Perceptions About Financial Statement Fraud and Their Use of Red Flags*, SSRN eLibrary (2009).
TINA D. CARPENTER, *Audit Team Brainstorming, Fraud Risk Identification, and Fraud Risk Assessment: Implications of SAS No. 99*, 82 Accounting Review 1119(2007).

T. JEFFREY WILKS & MARK F. ZIMBELMAN, *Decomposition of Fraud-Risk Assessments and Auditors' Sensitivity to Fraud Cues*, 21 Contemp. Acct. Res. 719(2004).
STEVEN M. GLOVER, et al., *A Test of Changes in Auditors Fraud-Related Planning Judgments since the Issuance of SAS No. 82*, 22 Auditing: A Journal of Practice and Theory 237(2003).
MARIA KRAMBIA-KAPARDISM, *A fraud detection model: A must for auditors*, 10 Journal of Financial Regulation and Compliance 266(2002).
CAROL A. KNAPP & MICHAEL C. KNAPP, *The effects of experience and explicit fraud risk assessment in detecting fraud with analytical procedures*, 26 Accounting, Organizations and Society 25(2001).
ROBERT J. NIESCHWIETZ, et al., *Empirical Research on External Auditors' Detection of Financial Statement Fraud*, 19 Journal of Accounting Literature 190(2000).
MARK F. ZIMBELMAN, *The Effects of SAS No. 82 on Auditors' Attention to Fraud Risk Factors and Audit Planning Decision*, 35 (Supplement) J. Accounting Res. 75(1997).
KAREN V. PINCUS, *The Efficacy of a Red Flags Questionnaire for Assessing the Possibility of Fraud*, 14 Accounting, Organizations and Society 153(1989).
W. S. ALBRECHT, et al., *Auditor Involvement in the Detection of Fraud*, *in* Management Fraud: Detection and Deterrence (R K Elliote & Willingham eds., 1980).
JANET COOPER ALEXANDER, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487(1996).
PAUL G. MAHONEY, *Precaution Costs And The Law of Fraud in Impersonal Markets*, 78 Va. L. Rev. 623(1992).
ELLIOTT J. WEISS & JOHN S. BECKERMAN, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053(1995).
PAUL G. MAHONEY, *The Exchange as Regulator*, 83 Virg. L. Rev. 1453(1997).
ADAM C. PRITCHARD, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 Va. L. Rev. 925(1999).
STEPHEN J. CHOI, *The Evidence on Securities Class Actions*, 57 Vand. L. Rev. 1465(2004).
TOM BAKER & SEAN J. GRIFFITH, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. Pa. L. Rev. 756(2009).
J. FRANCIS & D. WANG, *The joint effect of investor protection and Big 4 audits on earnings quality around the world*, 25 Contemp. Acct. Res. 157(2008).
JONG-HAG CHOI, et al., *Audit Pricing, Legal Liability Regimes, and Big 4 Premiums: Theory and Cross-country Evidence.*, 25 Contemp. Acct. Res. 55(2008).
LAWRENCE A. CUNNINGHAM, *Securitizing Audit Failure Risk: An Alternative to Caps on Damages*, 49 William & Mary L. Rev. 711(2007).
SADOK EL GHOUL, et al., *External versus Internal Monitoring: Do Western European Firms Rely More on Big Four Audits in the Absence of Multiple Large Shareholders and Families? at* http://ssrn.com/abstract=1373808.
ROSS J. WATTS & JEROLD L. ZIMMERMAN, *Agency Problems, Auditing, and the Theory of the Firm*, 26 J. L. & Econ. 613(1983).
GERARD HERTIG & HIDEKI KANDA, *Creditor Protection*, *in* The Anatomy of Corporate Law (Reineer et al. Kraakman ed. 2004).
WERNER F. EBKE, *In Search of Alternatives: Comparative Reflections on Corporate Governance and the Independent Auditor's Reponsibilities*, 79 Nw. U. L. Rev. 663(1984).
SEAN M. O'CONNOR, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. Rev. 741(2004).
JEAN TIROLE, The Theory of Corporate Finance (Princeton University Press. 2006).
ROBERT A. PRENTICE, *Can the Contributory Negligence Defense Contribute to a Defusing of the Accountants' Liability Crisis?*, Wisc. Int. Law J. 359(1995).

MATTHEW G. DORÉ, *Presumed Innocent Financial Institutions, Professional Malpractice Claims, and Defenses Based on Management Misconduct,* , 1995 Colum. Bus. L. Rev. 127(1995).
In re American International Group, Inc., Consolidated Derivative Litigation, 976 A.2d 872, (Ch. Del. 2009).
ln re American International Group, Inc., Consolidated Derivative Litigation, 965 A.2d 763, (Del. Ch. 2009).
ANDREW J. MORRIS, *Clarifying the Imputation Doctrine: Charging Audit Clients with Responsibility for Unauthorized Audit Interference*, 2001 Colum. Bus. L. Rev. 339(2001).
J.B. HEATON, *Deepening Insolvency*, 30 Iowa J. Corp. L. 465(2005).
CESARE VIVANTE, Trattato di diritto commerciale. Vol. II. Le società commerciali (Vallardi. 1929).
GUIDO FERRARINI, et al., *Company Law Reform in Italy: Real Progress?*, 69 Rabels Zeitschrift 658(2005).
RONALD H. COASE, *The Nature of the Firm*, Economica 4(1937).
LUCA ENRIQUES & PAOLO VOLPIN, *Corporate Governance Reforms in Continental Europe*, 21 J. Econ. Persp. 117(2007).
MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. L. Rev. 237(2009).
GUIDO FERRARINI & PAOLO GIUDICI, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case in* After Enron (John Armour & Joseph A. McCahery eds., 2006).
In Re Parmalat Securities Litigation, 2009 U.S. Dist. LEXIS 85523, (S.D.N.Y. 2009).
BRIAN CHEFFINS & BERNARD BLACK, *Outside Director Liabilities Across Countries,* 84 Tex. L. Rev. 1385(2006).
MANCUR OLSON, The Logic of Collective Action: Public Goods and the Theory of Groups (Harvard University Press. 1965).
ANITA ANAND & NIAMH MOLONEY, *Reform of the Audit Process and the Role of Shareholder Voice: Transatlantic Perspectives*, 5 EBOR 223(2004).
FRANK H. EASTERBROOK & DANIEL R. FISCHEL, The Economic Structure of Corporate Law (Harvard Univ. Press. 1991).
MARIO J. RIZZO, *A Theory of Economic Loss in the Law of Torts*, 11 J. Leg. Stud. 281(1982).
W BISHOP, *Economic Loss in Tort*, 2 Oxford Journal of Legal Studies 1(1982).
BRIAN R. CHEFFINS, *Auditors' Liability in the House of Lords: A Signal Canadian Courts Should Follow*, 18 C.B.L.J. 118(1991).
IVAN F. IVANKOVICH, *Accountants and Third Party Liability - Back to the Future*, 23 Ottawa L. Rev. 505(1991).
SABIN WILLETT, *The Shallows of Deepening Insolvency*, 60 Bus. Law. 549(2005).
HENRY T.C. HU & JAY LAWRENCE WESTBROOK, *Abolition of the Corporate Duty to Creditors*, 107 Colum. L. Rev. 1321(2007).
LORENZO STANGHELLINI, Directors' Duties and the Optimal Timing of Insolvency: A Reassessment of the "Recapitalize or Liquidate" Rule (2009).
RONALD J. GILSON & REINIER H. KRAAKMAN, *The Mechanisms Of Market Efficiency,* 70 Va. L. Rev. 549(1984).
STEPHEN J. CHOI, *Market Lessons for Gatekeepers*, 92 Nw. U.L. Rev. 916(1998).
SEAN M. O'CONNOR, *Strengthening Auditor Independence by Reducing the Need for It: Reestablishing Audits as Control and Premium Signaling Mechanisms*, ssrn 1(2006).
PAOLO GIUDICI, La responsabilità civile nel diritto dei mercati finanziari (Giuffrè. 2008).
ZOHAR GOSHEN & GIDEON PARCHOMOVSKY, *The Essential Role of Securities Regulation*, 55 Duke L.J. 711(2006).

PAUL DAVIES, Davies Review of Issuer Liability - Liability for misstatements to the market: A discussion paper by Professor Paul Davies QC (2007).
PAUL DAVIES, Davies Review of Issuer Liability: Final Report (2007).
EILIS FERRAN, *Are US/Style Investor Suits Coming to the UK?*, 9 J. Corp. L. Stud. 315(2009).
DAVID CHARNY, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 Mich. L. Rev. 1815(1991).
IAN AYRES & ROBERT GERTNER, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87(1989).
GIUSEPPE DARI MATTIACCI & HANS-BERND SCHÄFER, *The Core of Pure Economic Loss*, 27 International Review of Law and Economics 1(2007).
OLIVER KIM & ROBERT E. VERRECCHIA, *Pre-announcement and event-period private information*, 24 J. Acc. Econ. 395(1997).
OLE-KRISTIAN HOPE, et al., *Geographic earnings disclosure and trading volume*, 28 Journal of Accounting and Public Policy 167(2009).
ROBERT E. VERRECCHIA, *Essays on Disclosure*, 32 J. Acct. & Econ. 97(2001).
LUZ HAIL & CHRISTIAN LEUZ, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 Journal of Accounting Research 485(2006).
WARREN BAILEY, et al., *The economic consequences of increased disclosure: Evidence from international cross-listings*, 81 J. Fin. Econ. 175(2006).
RICHARD LAMBERT, et al., *Accounting Information, Disclosure, and the Cost of Capital*, 45 Journal of Accounting Research 385(2007).
R.K. ATIASE & L.S. BAMBER, *Trading volume reactions to annual accounting earnings announcements*, 17 J. Acc. Econ. (1994).
CHRISTIAN LEUZ & PETER WYSOCKI, *Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research*.
BRUCE CHAPMAN, *Limited Auditors' Liability: Economic Analysis and the Theory of Tort Law*, 20 C.B.L.J. 180(1992).
DONALD C. LANGEVOORT, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639(1996).
LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Sharing Damages Among Multiple Tortfeasors* 98 Yale L.J. 831(1989).
LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Apportioning Damages among Potentially Insolvent Actors*, 19 J. Leg. Stud. 617(1990).
LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Settlement Under Joint and Several Liability*, 68 N.Y.U. L. Rev. 427(1993).
LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Multidefendant Settlements Under Joint and Several Liability:The Problem of Insolvency*, 23 J. Leg. Stud. 517(1994).
LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Multidefendant Settlements: The Impact of Joint and Several Liability*, 23 J. Leg. Stud. 41(1994).
JOHN J. DONOHUE, *The Effect of Joint and several Liability on the Settlemente Rate. Matematicl Symmetries and Metaissues about Rational Liteigant Behavior. Comment on Kornhauser and Revesz*, 23 J. Legal Studies 543(1994).
LEWIS A. KORNHAUSER & RICHARD L. REVESZ, *Evaluating the Effects of Alternative Superfund Liability Rules*, *in* Analyzing Superfund: Economics, Science, and Law (Richard L. Revesz & R. Stewart eds., 1995).
LEWIS A. KORNHAUSER & RICHARD L. REVESZ, Joint and Several Liability § 2 (Peter Newman ed., 1998).
LEWIS A. KORNHAUSER & RICHARD L. REVESZ, Joint Tortfeasors (Boudewijn Bouckaert & Gerrit De Geest eds., Edward Elgar 2000).

ROBERT W. HAMILTON, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. Colo. L. Rev. 1065(1995).
JONATHAN R. MACEY & HILLARY A. SALE, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 Vill. L. Rev. 1167(2003).
HILLARY A. SALE, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 Wash. L. Rev. 429(2000).