Auditor Liability to External Users for Misleading Financial Statements of Publicly Listed Companies: Two Normative Propositions

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In his 2006 article, Professor Eric L. Talley undertook a limited, but important enterprise, to quantify the risk of cataclysmic legal liability faced by audit firms for failure to detect fraud in company prepared financial statements. Drawing primarily from the Securities Class Action Alert database, Professor Talley constructed a “conceptual diagram” to formulate the level of aggregate risk capable of threatening the viability of audit firms sustaining an adverse judgment. The enterprise contributed an objective framework to assist policymakers, both within and outside the United States, to develop appropriate regulatory reforms to address the audit industry’s demand to “limit exposure to liability from financial fraud that they fail to detect”. Since its publication, the article has retained its relevance, particularly given the recent collapse of Lehman Brothers Holding Inc. [LBHI] and the potential liability of its auditor Ernst & Young [E&Y], and the issuance of the European Union Recommendation to “cap” auditor liability. This article provides policymakers an extended perspective upon which to formulate legal reform and builds upon the extant literature by summarising the audit procedure and purported role of audited financial statements in the financial markets, and identifies flaws in the multiple paradigms of audit liability. The article articulates the case study of LBHI to advance two alternative normative propositions: (1) the audit firm should “sit on a knife’s edge” and legal principles should track professional standards, or, (2) legal policy should embody the commercial reality that audited financial statements are virtually worthless in terms of assuring the financial condition of companies. The conclusions follow logically from the audit process, the discordant legal paradigms, and empirical data demonstrating the inability of audit firms to achieve the vaunted objective of assuring accuracy of financial information.

Introduction

Financial statements of publicly listed firms are designed to “assist investors and creditors in deciding where to place their scarce investment resources”. These

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1 Professor of Law, Kazakhstan Institute of Management, Economics and Strategic Research; Associate Professor of Law, Riga International School of Economics and Business Administration; Director, Eurasian Institute of Law, Finance and Economics.

2 Eric L. Talley, Cataclysmic Liability Risk Among Big Four Auditors, 106 Colum. L. Rev. 1641 [2006]. The literature on auditor liability is vast: e.g., Jodi B. Scherl, Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences, 44 American Univ. L. Rev. 255 [1995][though a Comment, the article is complete and clear]; Anna Samsonova, Rethinking auditor liability: The case of the European Union’s regulatory reform [2010]; Ingrid De Poorter, Auditor’s liability towards third parties within the EU: A comparative study between the United Kingdom, the Netherlands, Germany and Belgium, Journal of International Commercial Law and Technology, Vol 3, Issue 1 [2008] p 68.

3 Eric L. Talley, supra n. 2 at 1642-43 stating, “Auditors are actively attempting to limit their exposure to liability from financial fraud that they fail to detect, responding to an expectations gap by filling a contractual one”.

4 Williams, Haka, Bettnner and Carcello, Financial Accounting (14th edition McGraw Hill) at 5. Put another way: “financial statements are “monetary declarations of what is believed to be true about an enterprise”. Id at 12.
statements impact the price of securities, since price is a function of a complex composite of data about publicly listed firms.\textsuperscript{5} External users, such as creditors and investors, rely upon financial statements to extend credit and to make investments decisions.\textsuperscript{5} Defective financial statements have the potential to cause cataclysmic damage to a foreseeable, though non-specific class of persons, as does the introduction of defective tangible products into the stream of commerce.\textsuperscript{7} Reliable financial statements are critical to an efficient allocation of capital and to efficient and stable markets in financial instruments.\textsuperscript{8} It naturally begs the question why auditors of financial statements for publicly listed companies should not be held to account for error stemming from negligence, recklessness, or fraud to the class of people to whom their legal and ethical obligations run.

Part I of this article reviews the audit procedure and the institutions that set audit standards and principles since the extant legal literature generally does not set forth the model of the audit process. Unlike the \textit{obiter dictum} found in cases such as \textit{Ultramares} and \textit{Caparo}, “a thoughtless slip or blunder”, a justified failure “to detect theft or forgery”, or the exercise of judgment in the interpretation of a rule cannot serve as a predicate to bring a claim against an audit firm. Audit firms adhering to the five phases of the audit process and adhering to applicable auditing standards likely would have “ironclad” protection from any claim mounted by the legal profession or regulatory agency. The remarkable question is why, in the limited but well published fiascos visited upon the auditing industry, the audit process has failed to meet professional standards?\textsuperscript{9} Lost in the argument of “cataclysmic risk” is the capacity of audit error to destabilize financial markets and contribute to the bankruptcy of large publicly listed firms, leading to massive economic damage often requiring public subsidy to avert systemic failure.

Part II of the article retells sections of the Report of Anton R. Valukas, Examiner, appointed by the United States Bankruptcy Court, Southern District of New York, to investigate the causes of the largest bankruptcy in the world, the failure of Lehman Brothers Holding Company Inc. [LBHI]. The “case study” of LBHI is a “prism” through which to identify and evaluate the applicable legal principles, policy considerations, and professional standards governing auditor liability.\textsuperscript{10} The Report provides a “treasure trove” of data and insight into LBHI economic events and the role of Ernst & Young [E&Y] in placing its unqualified imprimatur upon LBHI financial statements depicting a false representation of the financial condition of LBHI. The omission of E&Y to question off-balance sheet transactions is stunning in the context of the LBHI business model and its accounting practices. The Complaint of the Attorney General State of

\textsuperscript{5} This proposition is called the “Theory of Efficient Markets”. “The basis for the theory of efficient markets is the notion that the prices of all financial instruments, including stocks, reflect all available information”. Stephen G. Cecchetti and Kermit L. Schoenholtz, \textit{Money, Banking and Financial Markets}, [McGraw-Hill Irwin 3\textsuperscript{rd} ed. 2011] pp 194-95. While the Efficient Capital Markets Hypothesis has its detractors, in the case of LBHI, financial information disclosed to the public in 2008 about the firm’s financial condition moved the price of the stock more than 80% downwards.

\textsuperscript{6} External users range from investors, creditors, and owners to regulatory authorities. \textit{Id.} at 7

\textsuperscript{7} Grambling, Rittenberg, Johnstone, \textit{Auditing} (7\textsuperscript{th} edition South Western Cengage Learning) at 9.

\textsuperscript{8} “Certified public accountants serve a number of diverse parties but the most important [party] is the public … who make decisions based on financial and operating information about a company or other entity”.

\textsuperscript{9} Michael C. Knapp, \textit{Contemporary Auditing: Real Issues and Cases} [South Western Cengage 8\textsuperscript{th} ed. 2011] where Professor Knapp provides a comprehensive discussion and analysis of twelve audit failures from Enron Corporation to Madoff Securities.

\textsuperscript{10} LBHI filed for Chapter 11 bankruptcy protection at 1:45 a.m., on 15 September 2008 before the markets opened in Asia. Valukas Report, \textit{infra} n.5 at 13.
New York filed originally, with the Supreme Court of the State of New York, County of New York, against Ernst & Young [E&Y] is noted but the article draws no inference from this event. However, as of 27 July 2011, the most important litigation against E&Y is contained in In Re: LEHMAN BROTHERS SECURITIES AND ERISA LITIGATION in the Southern District of New York.\textsuperscript{11}

Part III of this article examines the dominant paradigms of legal liability of audit firms for failure to identify misrepresentations in management prepared financial statements. The article covers jurisprudence in the United States, the United Kingdom, and the European Union, and discusses the emerging trans-Atlantic trend to cabin the liability of audit failure based on concerns of cataclysmic liability and the probable exit of one of the Big Four firms from the audit industry. The thematic discussion does not omit fraud, but stresses that not even the European Union Recommendation exempts the audit industry from unlimited legal liability in the event of fraudulent conduct.

Part IV demonstrates the poverty of logic in most non-fraud paradigms of legal liability of audit firms and identifies the discordant relationship between the commercial reality of audit standards and extant legal regimes principles. Part V posits the question of audit firm liability within the LBHI “case study” and sets forth two normative solutions to the dilemma of audit firm liability to external users of publicly listed firms when the client firm files for bankruptcy.

I. Overview of the Audit Process

The audit opinion formulation process consists of five stages: (1) assessing client acceptance and retention decisions, (2) understanding the client, (3) collecting evidence about internal controls and determining their impact upon the audit process, (4) obtaining substantive evidence about account assertions, and (5) completing the audit and making an audit decision.\textsuperscript{12} Auditing is a deliberate, protracted, and complex process defined as a: “systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to users”.\textsuperscript{13} While management prepares financial statements, the “auditor’s job is to obtain reasonable assurance about whether management’s statements are materially accurate and to provide a publicly available report based on the auditor’s findings”.\textsuperscript{14}

An audit is conducted for the benefit of “third party users who have a vested interest in the organisation”. The auditor, while retained by the Board of the Directors of the firm, is in an adversarial role vis-à-vis management. “Certified public accountants serve a number of diverse parties, but the most important is the public, as represented by

\textsuperscript{11} In Re Lehman Brothers Equity/Debt Securities Litigation, 08 Civ. 5523 (LAK), United States District Court, Southern District of New York [In Re Lehman Brothers]. In addition, on 2 June 2011, Star International U.S.A. Investments LC and C.V. Starr & Co., Inc. Trust filed a complaint against E&Y seeking more than $200 million in damages. In his 106-page opinion, Judge Kaplan, on motions to dismiss The Third Amended Complaint, granted and denied the motions in parts. While beyond the scope of this article, the Judge Kaplan opinion raises numerous important and controversial legal issues.


\textsuperscript{14} Rittenberg, Johnstone, Gramling, *infra* n. 12 at 5.
investors, lenders, workers, and others who make decisions based on financial information about an organisation … In essence, certified public accountants should view themselves as guardians of the capital markets”.15 “The special function of auditors as guardians of capital markets reflects the language of Chief Justice Warren Burger in United States v. Arthur Young & Co., et al.16 An audit must root out fraud, enforce principles “that best portray the spirit of the concepts adopted by accounting standard setters, and be neutral to users and management”.17

Audited financial statements are important to capital markets because “a free market economy [depends] on the sharing of accurate, reliable information among parties that have a vested interest in the financial performance of an organisation … The reported data must reflect must reflect the economics of transactions and the current economic condition of assets controlled and obligations owed”.18 Whether any form of the Efficient Capital Market Hypothesis is accepted or rejected, information about firms remains the most important commodity of the capital markets as evidenced by the growing stream of audit failures of major companies. “During the past decade, many financial statement users – pension funds, private investors, venture capitalists and banks – lost billions of dollars because financial information, and, in some instances, the audit function, had become unreliable”.19

Since Congress enacted the Sarbanes-Oxley Act of 2002, the Public Company Accounting Oversight Board [PCAOB] is the most important institution to set audit standards in the United States. The PCAOB has four primary functions: “(1) registration of accounting firms that audit U.S. public companies, (2) periodic inspections of registered public accounting firms, (3) establishment of auditing and related standards for registered public accounting firms, and (4) investigation and discipline of registered public accounting firms for violations of relevant laws or professional standards”.20 The Securities and Exchange Commission [SEC], established in 1934, regulates the capital markets. The SEC has oversight responsibilities for the PCAOB and for all public companies gaining access to the U.S. capital markets. The SEC has the authority to establish GAAP; however, historically it has delegated that authority to the Financial Accounting Standards Board [FASB].

The American Institute of Certified Public Accountants [AICPA], though it has ceded its authority to the PCAOB to govern the public accounting profession, develops standards for non-public companies, conducts continuing education programmes, and through its Board of Examiners, administers the Uniform CPA examination. The International Auditing and Assurance Standards Board [IAASB] is part of the International Federation of Accountants [IFAC], a global organisation with 159 members in 124 countries as of 2009. The IAASB sets International Standards on Auditing (ISAs) and facilitates the

15 Id.
16 In a 1984 Supreme Court decision, Chief Justice Burger captured the essence of the auditor obligation, since adopted by every elementary textbook on the subject. The Chief Justice stated: “By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporations, creditors and stockholders, as well as to the investing public [emphasis added]. This “public watchdog function” demands … complete fidelity to the public trust”. U.S. v. Arthur Young & Co., et al, 465 U.S. 805 (1984) 817-18.
17 Rittenberg, Johnstone, Gramling, supra n. 12 at 6.
18 Id. at 4.
19 Id. at 7.
20 Id. at 11.
convergence of national and international auditing standards. While the SEC and FASB have traditionally set generally accepted accounting principles in the United States, the trend is to harmonise GAAP with International Financial Reporting Standards (IFRS), thereby achieving a globally uniform set of audit standards.

The AICPA and the IAASB have provided virtually identical guidance on the objective of an audit: “to obtain reasonable assurance about whether the financial statements are free from material misstatement and to report on the financial statements based on the auditor’s findings.”21 Achieving this objective requires that the auditor: (1) comply with relevant ethical requirements, (2) plan and perform an audit with professional scepticism (that is, question management assertions contained within the financial statements), (3) exercise professional judgment, (4) secure evidence to support the audit opinion, and (5) conduct the audit according to professional auditing standards.22

These objectives rest upon a foundation of ten standards developed by the ASB of the AICPA [Generally Accepted Auditing Standards or GAAS], and adopted by the PCAOB. The ten standards are contained within three categories: (1) general standards applicable to the auditor and audit firm, (2) fieldwork standards applicable to the conduct of the audit, and (3) reporting standards applicable to communicating the auditor’s opinion. In addition, the AICPA has developed fundamental principles to govern an audit that fall into four categories: (1) purpose and premise of the audit, (2) responsibilities of the professional, (3) performance, and (4) reporting. The IAASB 2010 standards comprise thirty-six International Standards on Auditing. The ten standards adopted by the PCAOB provide not only a conceptual framework but also sufficient detail to conduct a comprehensive audit to achieve the objective of assessing assertions against criteria and evidence.

Without elaborating the five phases of the audit procedure, an objective beyond the scope of this article, select observations of each phase demonstrate how audit standards attempt to produce independent assurance on financial data. Audit firms minimise risk by client selection and retention [Phase I]. Audit firms are under no obligation to provide services to firms and have the option to avoid unnecessarily high-risk clients by reviewing, for example, the company’s past performance, business model, and history of regulatory action. Understanding the client’s business [Phase II] segues smoothly with Phase I. Not only must the audit firm learn and understand the business of its client but also must gauge the appropriate level of materiality to apply to the economic events and transactions of the company. Knowing the client requires a review of management compensation plans, internal control procedures, and accounting policies. Acquiring this information permits the audit firm to develop a plan designed “to provide reasonable assurance that material misstatements will be detected”, and appropriate disclosures will be made in notes to the financial statements.23

Phases III [evidence collection] and IV [test of assertions] arguably constitute the gravamen of the audit. “An assertion is a statement about an action, event, condition, or performance over a specified period of time” made by management.24 Take Property, Plant and Equipment [PPE]. The audit firm must assure that all purchases are accurately recorded as per invoice and valued at cost with allowances for depreciation. Inventory is

21 Id. at 15.
22 This language paraphrases that of Rittenberg, Johnstone and Gramling, supra n 12 at 15.
23 Id. at 18.
24 Id.
another asset requiring verification as to an accurate statement of value and allowance as flawed audit procedures regarding inventory have played a role in the collapse of Health Management, Inc., Crazy Eddie, Inc., and Just for FEET, Inc.25 Professional standards do not require audit firms to test all assertions but rather devise a plan to select a sample, review documentary evidence and inquire and corroborate assertions represented by management. Closing the audit and reaching a reporting decision [Phase V] involves a summary of the audit evidence and the exercise of professional judgment as to whether account balances are fairly represented in the financial statements.

US GAAP requires financial statements to achieve the “ultimate goals of fairness and accuracy in reporting and require more than technical compliance”.26 The court in In re Global Crossing Ltd. Securities Litigation, explained that “when viewed as a whole,” GAAP has no “loopholes” because its purpose, shared by the securities laws, is “to increase investor confidence by ensuring transparency and accuracy in financial reporting.”27 Technical compliance with specific accounting rules does not automatically lead to fairly presented financial statements. “Fair presentation is the touchstone for determining the adequacy of disclosure in financial statements. While adherence to generally accepted accounting principles is a tool to help achieve that end, it is not necessarily a guarantee of fairness.” Moreover, registrants are “required to provide whatever additional information would be necessary to make the statements in their financial reports fair and accurate, and not misleading”.

The level of difficulty of the audit process is not to be underestimated, given complex transactions, and management’s desire to present the firm in its best financial light. The relationship between the audit firm and the client also exacerbates the audit firm’s commitment to independence since the auditor must “bite the hand that feeds it”. Nevertheless, an audit firm adhering to the textbook model of an audit procedure and meeting its ethical obligations is unlikely to encounter a cataclysmic legal liability for placing its imprimatur upon flawed financial statements.

II. The LBHI “Case Study”

On 18 September 2008, Lehman Brothers Holdings Inc. [LBHI], the fourth largest investment bank in the world, filed a petition for bankruptcy with the United States Bankruptcy Court for the Southern District of New York. The bankruptcy filing was the largest in history, as LBHI had $639 billion in assets and $619 billion in debt, surpassing the bankruptcies of Enron and WorldCom. Founded originally in 1850, by the two sons of a German emigrant in Alabama, the firm survived the calamities of the Great Depression, the Two World Wars, and the Russian default crisis of 1998, and expanded into an international investment bank, establishing presence in numerous countries. The dramatic rise and fall of LBHI is demonstrated by comparing its February 2007 stock price of $86.18, giving the firm a market capitalisation of nearly $60 billion, with its September 2008 stock price of $3, a plunge of more than 93%. The failure of LBHI contributed significantly to the $10 trillion erosion of global market equity in October 2008.

25 Michael C. Knapp, supra n 9 at 23 [Just for FEET, Inc.]; 45 [Health Management, Inc.]; and 99 [Crazy Eddie, Inc.].
27 Id.
On 19 January 2009, the U.S Trustee for LBHI, acting under an Order dated 16 January 2009 entered by the United States Bankruptcy Court for the Southern District of New York to nominate an Examiner, appointed Anton R. Valukas as Examiner. The Court approved the appointment on 20 January 2009. The Examiner was obligated to investigate the causes of the failure of LBHI and to file a statement of any facts “pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity” in the management of the debtor.28 The Report of Anton R. Valukas [Valukas Report or VR], Examiner in In re LEHMAN BROTHERS HOLDINGS INC., et al consists of nine volumes and was issued 11 March 2010.29 The Valukas Report is the result of reviewing millions of documents, interviewing witnesses, and cooperating with the U.S. Government and the parties. The spectacular failure of LBHI and the extensive data found in the VR establish LBHI as a case study par excellence for the project undertaken in this Article.

Subsequently, on 21 December 2010, the Attorney General of the State of New York filed a Complaint against Ernst & Young [E&Y] in the Supreme Court of the State of New York, County of New York. The Complaint charges E&Y with fraud in four counts by substantially assisting LBHI “to engage in a massive accounting fraud”. Three counts are based on violations of a New York statute, the Martin Act, and one count on a violation of Executive Law §63.30 In February 2011, on a motion by E&Y, the case was transferred to the United States District Court, Southern District of New York.31 The case revolves around the use by LBHI of Repo 105 transactions during period end adjustments to the balance sheet. The Attorney General maintains that the “repo” transactions were incorrectly deemed sales and not treated as short term financing arrangements. The audited financial statements of LBHI did not contain disclosure notes pertaining to the transactions.

The “case study” spins the story of the LBHI and E&Y relationship primarily from these two sources. Due to the size of the VR, the breadth and complexity of the issues, this “case study” is limited primarily to the Examiner’s findings as to the factors causing the collapse of LBHI and the relationship between LBHI and E&Y, focusing upon transactions coded “Repo 105” and “Repo 108”. In contrast to the NY Attorney General, the Securities and Exchange Commission refrained from bringing any charges against E&Y, citing “daunting hurdles” to obtaining civil judgments or criminal convictions against the firms former executives, and refrained from bringing any claim against E&Y maintaining the accounting manoeuvres, while controversial, were not illegal.32

LBHI was an investment bank founded upon a business model of high risk and high leverage. The asset side of the balance sheet was long term and the liability side of the balance sheet was short term. Hence, LBHI required daily infusions of short term financing in amounts exceeding tens of billions of dollars to stay open for business. The confidence of its counterparties was critical to its business model given its addiction to

29 United States Bankruptcy Court, Southern District of New York, Chapter 11 Case No. 08-13555 (JMP). The report may be found at the web site of the Examiner's law firm of Jenner & Block LLP: http://lehmanreport.jenner.com/, last visited 9 May 2011.
31 The attorney general's case is New York v. Ernst & Young LLP, U.S. District Court, Southern District of New York No. 11-00384.
32 Wall Street Journal, Eaglesham and Rappaport, Lehman Probe Stalls; Chance of No Charges, Mar. 12, 2011
debt financing. Rating agencies, creditors, and analysts required that LBHI have a favourable net leverage ratio compared to its peers in the investment banking industry. That metric was the *sine qua non* of market confidence. LBHI delivered that metric by engineering its balance sheet at period end to meet quarterly expectations. The engineering of the balance sheet created an illusion of liquidity by using transactions coded “Repo 105” and “Repo 108” never disclosed in its periodic and annual reports. Living on the knife's edge of off-balance sheet transactions proved unsustainable. In 2008, LBHI reported a $2.8 billion loss in the second quarter and a $3.9 billion loss in the third quarter. The illusion of liquidity imploded and produced a financial tsunami wiping out a 29 February 2008 market capitalization of $30 billion.  

Three events mark critical turning points leading ultimately to the collapse of LBHI. In 2000, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 140 that subject to mandatory criteria, permitted firms to recharacterise ordinary “repo” transactions as sales of inventory with a forward purchase agreement.  

Second, in 2006, LBHI undertook an aggressive “countercyclical growth strategy” to spend capital to acquire Collateralised Mortgage Backed Securities [CMBS] and Retail Mortgage Backed Securities [RMBS] thereby expanding geometrically its holdings in the distressed commercial and retail real estate market. “The total illiquid positions on Lehman's balance sheet increased from $41 billion in 2006 to $115 billion and $120 billion in the first quarter of 2008”. Third, LBHI, relying upon SFAS 140, undertook an aggressive accounting strategy to lower its net leverage to meet market expectations.

Net leverage is a financial ratio designed to indicate a borrower's ability to repay its debts. LBHI measured gross net leverage by taking total assets and dividing them by total stockholders’ equity. Deducting the value of collateralized agreements from total assets and dividing by total stockholders’ equity resulted in net leverage ratio. LBHI used Repo 105 and Repo 108 transactions to reduce net leverage ratios when periodic reports were made public as required by government regulation and stock exchange rules. This accounting device allowed LBHI to reduce its net leverage ratio by whole numbers thereby depicting a false picture of the financial strength of the firm to repay debt from current assets.

An ordinary “repo transaction” involves the transfer of liquid securities in exchange for cash with a simultaneous agreement to repurchase the securities for cash plus interest at a specified date in the very short term. The value of securities transferred ordinarily exceeds the value of cash by 2%, or in the parlance of investment banking a “haircut”. An ordinary repo increases both sides of the balance sheet by increasing cash position and adding collateralised debt obligations. Total balance sheet and leverage increase. In an ordinary repo transaction, the securities transferred are not removed from the inventory of the borrower and the obligation to repurchase the assets increases liability. In short, a “repo” is a form of secured short term financing.

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33 “LBHI, Quarterly Report as of Feb. 29, 2008 (Form 10-Q)(filed on Apr. 9, 2008) at p.1 (“LBHI 10-Q Apr. 9, 2008) (554 million common equity shares outstanding times $55 = approximately $30 billion)”. See, Valukas Report, supra n. 5 at p. 2 n.4.


35 Valukas Report, supra n 5 p 836.
Unlike a borrowing, Repo 105 and Repo 108 transactions, though structurally and substantively identical to ordinary repos, are off-balance sheet transactions. The term “Repo 105” refers to the increased “haircut” taken by LBHI from 2% to 5%, and the term “Repo 108” refers to the increased “haircut” from 2% to 8%. Since a Repo 105 transaction is deemed a “sale” under SFAS 140, LBHI removed from its inventory on the balance sheet, the securities put up as collateral for the loan, and reduced the liability side of the balance sheet by using the cash received from the loan to pay off short-term liabilities. The single transaction “killed two birds with one stone”: reduction of both sides of the balance sheet and production of a lower net leverage ratio. LBHI did not disclose in a note to its financial statements the unconditional obligation to repurchase the securities at a date certain. In short, LBHI borrowed billions of dollars without disclosing this information to the public.

An illustration taken from the VR depicts the mechanics of the Repo 105 transaction. Assume LBHI executes $50 billion of Repo 105 transactions. The transaction is characterized as a sale and $50 billion of financial instruments, considered sold, are removed from the balance sheet. Lehman receives $50 billion in cash; so total assets are unchanged. “Lehman records no liability to return the cash borrowing so likewise liabilities remain unchanged thereby leverage is unaffected” as following illustration taken directly from the Valukas Report demonstrates:

<table>
<thead>
<tr>
<th>Assets [millions]</th>
<th>Liabilities and OE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$57,500(^{37})</td>
</tr>
<tr>
<td>Financial Instruments</td>
<td>300,00</td>
</tr>
<tr>
<td>Collateralised Agreement</td>
<td>350,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>20,000</td>
</tr>
<tr>
<td>Other</td>
<td>72,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>800,000</strong></td>
</tr>
</tbody>
</table>

Gross Leverage 30  
Net Leverage 17

If this were the result, LBHI would not have engaged in such a transaction. However, LBHI immediately used the cash to pay down short-term borrowings such as other repo transactions and thereby achieved its goal of reducing leverage as the next illustration taken from the Valukas Report demonstrates:

<table>
<thead>
<tr>
<th>Assets [millions]</th>
<th>Liabilities and OE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>7,500</td>
</tr>
<tr>
<td>Financial Instruments</td>
<td>300,00</td>
</tr>
</tbody>
</table>

\(^{36}\) The counterparties did not demand the increased “haircuts”; rather LBHI thought them necessary to meet the criteria of FAS 140.

\(^{37}\) Prior to the transaction cash was 7,500; likewise financial instruments were 350,000.
<p>| | | |</p>
<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Collateralised Agr.</td>
<td>350,000</td>
<td>Long term borrowings</td>
</tr>
<tr>
<td>Receivables</td>
<td>20,000</td>
<td>Payables</td>
</tr>
<tr>
<td>Other</td>
<td>72,500</td>
<td>OE</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>750,000</strong></td>
<td><strong>750,000</strong></td>
</tr>
</tbody>
</table>

When the repo matured, LBHI borrowed funds to repay the Repo 105 borrowing plus interest, and the securities were returned to its inventory. “Accordingly, total assets and liabilities increased”. 38

While there is nothing wrong *per se* by reclassifying a “repo transaction” as a sale with a forward agreement to repurchase under SFAS 140, there were many things wrong with LBHI’s use of this accounting standard. First, the transactions lacked economic substance or business purpose. The primary purpose of engaging in Repo 105 or Repo 108 transactions at the near-end of each quarter was to remove securities from the balance sheet, use cash to pay down short-term liabilities, and, contrary to reality, report lower net leverage ratios. Second, SFAS 140 requires firms to obtain a letter from a law firm to attest that the transfer is a “true sale” in law. LBHI could not obtain such a letter from any U.S. law firm. Hence, it requested, and obtained, a “true sale” opinion from the UK firm of Linklaters on behalf of its UK subsidiary Lehman Brothers International Europe [LBIE]. The Linklaters “true sale” opinion was premised upon UK law and applied solely to LBIE trading with firms located in the European Union. 39 The Linklaters opinion did not address the question of using securities originating in the United States, followed by an intercompany repo to transfer the securities to LBIE, enabling the London subsidiary to “sell” the securities to a European bank, and then, at the time of repurchase, entering into a second intercompany repo to transfer the securities back to LBHI in New York.

The accounting system used by LBHI in New York and LBIE in London automatically classified all repo transactions as “borrowings”; thus it was necessary that LBHI and LBIE employees manually enter the accounting system to reclassify the Repo 105 and Repo 108 transactions as “sales”. The Valukas Report provides: “In short, Lehman undertook transactions in a foreign jurisdiction (the United Kingdom) that purported to comply with SFAS 140, where Lehman was unable to obtain a SFAS 140 true sale opinion from a United States law firm, and Lehman then relied upon the non-United States-based Lehman entity to ensure that the transaction complied with United States GAAP”. 40

In 2007 and 2008, LBHI’s financial position worsened due to its misguided decision taken in 2006 to increase its real estate holdings, both commercial and retail, betting against the market’s view that these assets would diminish in value. The Valukas Report

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38 Valukas Report at 760.
39 Id. at 23. See discussion infra fn 85 for a precise discussion of this issue. Judge Kaplan in his opinion stated, without citation, that SFAS 140 did not require the opinion of US law firm determining that the use in the United States of an SFAS 140 Repo was valid.
40 Id. at Vol. 3 86.
refers to these assets as “sticky” meaning that LBHI would incur substantial losses if the assets were sold. The need to provide the market with an impression of a low net leverage ratio and to mitigate the possession of toxic assets placed LBHI between a “rock and a hard place.” Management decided to increase the volume of Repo 105 and 108 transactions to meet quarterly expectations and refused to consider the sale of “sticky” assets that would reveal to the market its poor financial position. The quarter end use of Repo 105 and 108 transactions further evidences that the transactions were undertaken for balance sheet engineering.

LBHI appointed Bart McDade as balance sheet “czar”. McDade viewed the use of Repo 105 transactions as undisciplined and intended to implement a programme to reduce their use and to remove “sticky” assets off the balance sheet. “In his role as balance sheet czar, McDade created a Daily Balance Sheet and Disclosure Scorecard report in order to have greater transparency with respect to the balance sheet. The Daily Scorecard was widely disseminated among senior Lehman management from April through September 2008 and routinely contained references to the impact Repo 105 transactions had on Lehman’s daily balance sheet”. In a meeting convened with the Executive Committee, McDade stated, that “in order to make the seismic change” he wanted to accomplish with the balance sheet in March 2008, Lehman “had to make big changes,” which included significantly reducing or ceasing the firm’s use of Repo 105 transactions”. McDade wanted traders to sell assets and stop renting the balance sheet. He stated, “In other words, when traders found it hard to sell sticky assets or wanted to avoid selling them at a discount, they knew that they could “rent the balance sheet,” … by removing certain inventory temporarily through Repo 105 transactions while allowing other inventory to remain on the balance sheet and still reach Lehman’s balance sheet targets”.

Contrary to internal discussion of balance sheet engineering, LBHI presented a totally different picture of its financial condition and strategy in earnings calls and press releases. LBHI spoke about its aggressive efforts to deleverage by managing the size of its firm-wide balance sheet. LBHI never disclosed that, particularly in 2007 and 2008, it was relying upon an expanded use of Repo 105 transactions at quarter end to meet its balance sheet targets when market conditions declined. “Similarly, [LBHI] never disclosed that its net leverage ratio – which Lehman publicly touted as evidence of its discipline and financial health – depended upon Lehman’s Repo 105 practice”. The following statement from the Valukas Report poignantly and powerfully captures this deception: 

“During the first quarter 2008 earnings conference call, then-Chief Financial Officer Erin Callan remarked that since the previous quarter, Lehman had been “trying to give the group [i.e., the analysts] a great amount of transparency on the balance sheet.” At no time, however, did Callan or anyone else from Lehman disclose the firm’s use of Repo 105 transactions to manage the balance sheet. Callan told the analysts that Lehman “did, very

41 In terms of engineering the balance sheet to meet quarterly targets, the worst offender among numerous LBHI divisions was the Fixed Income Division [FID]. For example, in January 2008, FID held $115.857 billion in illiquid assets [55.747 billion was in real estate]. Similarly, in April 2008, FID listed $108.75 billion in illiquid assets. According to the Valukas Report, the amount of illiquid assets was so large that they were referred to as “dead asset schedules”. FID had no alternative but to increase the use of Repo 105 transactions to meet managements’ balance sheet targets.

deliberately, take leverage down for the quarter. We ended with a net leverage ratio of 15.4 times down from 16.1 at year-end. And we will continue to allocate capital on the balance sheet in a way that we consider prudent, and that reflects the liquidity profile of the balance sheet.” When Callan briefly addressed Lehman’s ordinary repo transactions during the first quarter 2008 earnings call, she made no mention of Lehman’s Repo 105 program”. (Footnotes omitted)  

The failure to report accurately the internal business decisions of the firm continued throughout 2008. In a June 2008 conference call, Ian Lowitt, who had replaced Callan as LBHI CFO, stated on a call:

“Asked whether the sales by which Lehman achieved the balance sheet improvements were “pretty much ratably spread over the quarter or were they more skewed toward either the early or latter part of the quarter,” Lowitt replied that the sales “were spread over the whole quarter.” Lehman’s use of Repo 105 transactions, however, spiked at quarter-end, including the end of the second quarter 2008. For example, the total amount of assets involved in Repo 105 transactions on April 30, 2008 was $24.74 billion, but increased to $50.38 billion on May 30, 2008, at Lehman’s quarter-end”. (footnotes omitted)

These arguably misleading statements to analysts continued until the firm collapsed in September 2008. As stated by the Examiner:

“When senior management gave balance sheet targets to business divisions within Lehman, the orders were given so that the firm could manage its business towards a target net leverage ratio with an eye toward rating agencies and the firm’s public disclosures. Lehman used SFAS 140’s true sale accounting treatment for Repo 105 transactions and Repo 105 cash borrowings to make its balance sheet appear stronger than it actually was. In order for this off-balance sheet device to benefit Lehman, the firm had to conceal information regarding its Repo 105 practice from the public”. (footnotes omitted) LBHI never disclosed its accounting treatment or use of Repo 105 transactions in its Forms 10-K and 10-Q. 44 In short, “the documentary evidence and witness statements established that LBHI employed Repo transactions for quarter end balance sheet reduction, as demonstrated vividly by fact that Repo 105 transactions spiked up at quarter end, [as demonstrated by the following chart]” 45

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44 Significantly, LBHI outside counsel for disclosures, Simpson, Thatcher & Bartlett, was unaware of LBHI’s use of Repo 105 by name and did not know the purpose of these transactions. LBHI Senior Vice President of External Reporting upon whom Simpson Thatcher & Bartlett relied for information never disclosed the practice, though he knew that they did not serve any legitimate business purpose. VR, Vol III 856.
The Examiner concluded that, “There is sufficient evidence to support a determination by a trier of fact that Lehman’s failure to disclose that it relied upon Repo 105 transactions to temporarily reduce the firm’s net balance sheet and net leverage ratio was materially misleading”. In addition, the Examiner concluded that a trier of fact could find that Lehman “affirmatively misrepresented” its financial statements by treating repo transactions as ordinary borrowings when in fact Repo 105 transactions, amounting to tens of billions of dollars, were treated as “true sales”. Based upon these conclusions, the Examiner found that there was sufficient evidence to support a determination by a trier of fact that Lehman officers breached their fiduciary duties to the Board of Directors.

The information was material. Quoting the Examiner, “Information is deemed material if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” In addition, “materiality does not require … that the information be of a type that would cause an investor to change his investment decision”. Moreover, even if LBHI technically complied with SFAS 104, compliance does not operate as a defence or provide insulation from liability, if the firm’s financial statements, taken as a whole, were materially misleading.

Crucial for this Article, “The Examiner conclude[d] that sufficient evidence exists to support colorable claims against Ernst & Young LLP (E&Y) for professional malpractice arising from E&Y’s failure to follow professional standards of care with respect to communications with Lehman’s Audit Committee, investigation of a whistleblower claim, and audits and reviews of Lehman’s public filings”. Generally Accepted Auditing Standards [GAAS] mandate that a primary responsibility of an external auditor “is to

47 The principle of “materiality” is one of the most fundamental accounting principles and permeates the entire accounting function, as information deemed material must be disclosed in the financial statements. It is taught to first year accounting students. There is no possibility that LBHI officers and Ernst & Young auditors could have been unaware of the principles of materiality.
express an opinion whether the company’s financial statements are presented fairly, in all material respects, in accordance with Generally Accepted Accounting Principles [GAAP]”. In addition, E&Y had an obligation to adhere to the Sarbanes-Oxley Act of 2002 [SOX] and the standards and rules of the Public Accounting Oversight Board [PCAOB] established by SOX. The PCAOB, at all times pertinent to LBHI’s use of Repo 105 and Repo 108 transactions, had adopted the GAAS standards, as interim auditing standards.

The Examiner’s final conclusions are worth quoting:

“The Examiner finds that sufficient evidence exists to support at least three colorable claims that could be asserted against Ernst & Young relating to Lehman’s Repo 105 activities and reporting: (1) negligence in connection with the investigation into whistleblower Matthew Lee’s claims concerning $50 billion in Repo 105 activities at the end of the second quarter 2008, including failing to conduct an adequate inquiry into the allegations prior to the filing of Lehman’s Form 10- Q, and failing to properly inform management and the Audit Committee of Lee’s allegations; (2) at least with respect to Lehman’s first quarter and second quarter 2008 Forms 10- Q, if not with respect to earlier filings, negligence by failing to take proper action when Ernst & Young was made aware that the financial information may be materially misleading because of the failure to disclose the effect of the timing and volume of Lehman’s Repo 105 activities (which had a material effect on interim financial statement items), and failing to take proper action with respect to materially misleading statements contained in the MD&A sections of the Forms 10- Q for these quarters; and (3) at least with respect to Lehman’s 2007 Form 10- K, if not with respect to earlier Forms 10- K, negligence by failing to take proper action when Ernst & Young was made aware that the financial statements may be materially misleading because of the failure to disclose the effect of the timing and volume of Lehman’s Repo 105 activities (which had a material effect on financial statement items), and failing to take proper action with respect to materially misleading statements contained in the MD&A sections of the Form 10- K.”

While the “case study” does not benefit from the arguments or data in possession of E&Y and not contained in the VR, nevertheless, the “case study” provides a powerful example within which to view auditor liability to external users of financial statements under extant legal principles.

III. Extant Legal Paradigms

The following paradigms arguably constitute the gamut of legal rules in the US and EU applicable to audit firm liability to non-contractual users of audited financial statements: (1) the US federal system of fraud, (2) the “privity” citadel, (3) the Restatement (Second) of Torts approach, (4) the foreseeability test, and (5) capping liability and sanctioning limited liability agreements between audit firms and clients. The discussion is not

48 VR, Vol. III, p. 1028
exhaustive, as the literature provides sufficient depth, but is representative of core assumptions and rules.

A. The US Federal Antifraud System

Professor Talley maintains correctly that US federal law is the central source of liability faced by auditors in the United States. “The three most salient sources of auditor liability emanate from section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), section 11 of the Securities Act of 1933 (Securities Act), and section 13(b) of the Exchange Act”.

Professor Talley, citing an unpublished manuscript notes, “A recent study … suggests that since 1977, American firms have paid just under $14 billion in fines, disgorgements, or civil remedies to either the SEC or private plaintiffs under federal securities fraud litigation.” The US Federal antifraud system is the domain of regulatory action and private class action lawsuits, provided the latter are permitted by statute or implied by case law thereby constituting a threat to audit firms engaged in fraudulent activity.

Rule 10(b)-5, the federal implementation of Section 10(b), is the “crescent wrench of the securities fraud toolbox”. The rule prohibits any person from “employ[ing] any device, scheme or artifice to defraud”; from making any “untrue statement of material fact” or omitting facts “necessary to in order to make the statements made, in the light of the circumstances under which they were made, not misleading”; and from engaging in “any act, practice, or course of business which operates or would operate as a fraud or deceive upon any person in connection with the purchase or sale of any security”.

The claimant bears a substantial burden of proof: (1) the existence of a false statement or omission in connection with a purchase or sale of a security, (2) made with appropriate level of scienter: knowledge or recklessness, (3) the statement or its omission was material, (4) reliance, (5) causation to enter into the transaction, (6) loss resulting from the reliance and causation, and (7) proof of money damages. In 1988, the US Supreme Court relaxed the reliance requirement for unsophisticated investors by adopting the “fraud on the market theory” [FOM], a doctrine presuming that the price of securities consists of all publicly available information including audited financial statements. The effect of this theory is that a shareholder has potential standing to file a 10b-5 claim if the shareholder bought shares while the price of the securities was artificially high due to misleading financial statements and sold them at a loss when the fraud was revealed. The Congressional enactment of the Private Securities Litigation Reform Act [PSLRA] established a counter-weight to the FOM theory by introducing for private plaintiffs stricter pleading requirements.

Section 11 of the Securities Act of 1933 provides an effective remedy when the fraud is seated in a registration statement required to offer the sale of securities to the public. Section 11 explicitly provides a private cause of action and eliminates the scienter requirement. Section 11(a) “provides that a person acquiring a security covered by a registration statement may recover damages on a joint and several basis from the issuer,

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51 Eric L. Talley, supra n 2 1650.
53 Id. at 1652.
54 17 C.F.R. §240.10b-5(a)-(c) (2006).
55 Basic, Inc. v. Levinson, 485 U.S. 224, 241-42.
its directors, its officers who signed the registration statement, the accountants and other experts named in the registration statement … if ‘any part of the registration statement, when such part became effective, contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading’.” The PSLRA did not affect or limit a Section 11 private action.

Section 13(b) of the Securities Exchange Act of 1934 is a third major weapon in the Federal arsenal to impose liability upon audit firms. Section 13(b) delegates authority only to public authorities and empowers the government to prosecute financial misrepresentations without demonstrating intent. Section 13(b) in its current form benefitted from two statutory amendments: the Foreign Corrupt Practices Act of 1977, and the Sarbanes Oxley Act of 2002. Section 13(b)(2)(a), incorporating the FCPA accounting provisions, requires firms subject to the Exchange Act to keep records and books that accurately reflect corporate payments and transactions and to design a system of internal controls to assure that management imposes control over the company’s assets. Section 404 of SARBOX augments the FCPA amendments by requiring reporting companies to state in their annual reports a description of the internal control system developed to assure the integrity of financial reporting. Audit firms are required to review and assess the internal control system.

In 2004, the Public Company Accounting Oversight Board promulgated Auditing Standard No. 2. That standard requires the audit firm to set forth an opinion as to whether management’s representations about its internal control system “is fairly stated in all material respects”. The audit firm is obligated to make certain that the firm’s internal control system does not contain any “material weakness” at the time management produced its financial statements. Professor Talley remarks, “therefore, the objective of the audit of internal control over financial reporting is to obtain ‘reasonable assurance’ that no material weaknesses exist as of the date specified in management’s assessment’.” Since the focus of this article is not fraud, additional facets of the “fraud paradigm”: RICO, obstruction of justice and criminal prosecutions, are omitted.

B. The “privity” citadel

In 1931, Benjamin J. Cardozo, in Ultramares Corp. v. Touche Niven & Co., applied the privity doctrine to deny recovery to a non-client “who alleged that he had lost money as a result of his reliance upon an auditor’s negligent certifications”.

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In Ultramares, Fred Stern & Co. [Company], an importer and seller of rubber, engaged the accounting services of Touche, Niven & Co. [Auditors] in 1924 to prepare and certify the company’s balance sheets as of year-end 1923. The Company relied heavily upon financing from banks and other lenders to conduct its business. To obtain that financing the Company submitted its certified balance sheets to prospective lenders to obtain extensions of credit. The Auditors knew these critical facts of the Company. The 1924 audit contained a statement that the balance sheets for the year ending 1923 “presents a true and correct view of the financial condition” of the Company.

The balance sheet showed assets in the sum of $2,550,671.88, liabilities in the sum of $1,479,956.62, and owner’s equity of $1,070,715.26. The Auditors provided 32 certified balance sheets since it knew that the Company needed them to submit to prospective creditors. However, contrary to the

58 Id. at 174.
strong financial condition depicted in the balance sheets, the Company was insolvent, due to falsified Accounts Receivables records and other Assets.

In 1924, the Company approached Ultramares [Factor] to request loans to finance its business activity of selling rubber. Relying upon the balance sheets of the Company, the Factor provided a series of loans based upon the Company’s assignment of its Accounts Receivables as security for its credit extensions. In December 1924, approximately one year after the Auditors had certified the 1923 balance sheets, the “house of cards collapsed”, and the Company was declared bankrupt in January 1925. Ultramares filed claims against the Auditors on two grounds of non-contractual obligation: a cause of action in tort based upon misrepresentation, and a cause of action in tort for fraud. After a trial on the claim of knowing misrepresentation, the jury returned a verdict against the Auditors in the amount of $187,576.32, apparently the total sum lost by the Factor.

Cardozo found that the Auditors were negligent on four counts: (1) failure to verify Assets, (2) failure to verify Accounts Payable, and (3) failure to verify inventory, and (4) failure to verify that identical accounts were pledged to several creditors. Without recounting details, the conduct of the Auditors, with respect to verification of Accounts Receivables, flagrantly deviated from professionally accepted audit standards. After the Auditors’ junior accountant had posted all items in the journal to the general ledger showing a total amount of receivables in the amount of $644,758.17, an employee of the Company subsequently entered in handwriting an additional item in the sum of 706,843.07. Without referring to the journal or checking the underlying invoices, the junior accountant simply added the new entry to his own computation with the result that Assets of the Company were overstated by an amount of $700,000.

Cardozo’s finding that the Auditors were negligent did not end his inquiry into liability embodied in the jury verdict. The critical issue was characterised as to whom did the Auditors owe a duty of care to conduct an Audit without the compass of negligence? While admitting that the Auditors owed a duty to the Company to refrain from fraud as the Auditors had notice of the Company’s use of the balance sheets to obtain external financing, Cardozo declined to extend a duty of care to the Factor, and therefore the Factor was unable to recover its losses on a theory of negligence. Cardozo’s reasoning is nuanced and carefully parsed thereby justifying an inquiry into the rational of Ultramares.59

Cardozo starts with a conclusion and works backward to justify his judgement. He states: “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”.60 The opening salvo is followed by a series of observations, related and unrelated to the foregoing conclusion, setting the stage for his novation of the legal question: Liability to the world for an erroneous opinion or negligent speech. Contrary to established audit principles, Cardozo notes, fully committing himself to privity, that “the service was primarily for the benefit of the Stern company, a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those

59 As demonstrated later, the opinion, except for its observations on fraud, is incoherent, confusing speech with service, and reposing upon flawed analogical reasoning.
60 Id. at 179.
to whom Stern and his associates might exhibit it thereafter”.  

No support is provided for this critical fact upon which the opinion is grounded.

This observation is followed by reference to three cases offered by the Factor in support of its position. Cardozo distinguishes them from *Ultramares*, though not very convincingly and insufficiently covers his “hidden” political agenda. The “coup de grace” is completed by reference to two cases deemed an antidote to the three decisions that potentially opened the door to third party liability for negligent service or speech. In the first, a supplier of ticker tapes to the stock exchanges was held not liable for error found in stock quotations to protect its proprietors: newspapers. In the second case, relying upon the pronouncement of Judge Pound, Cardozo found that “words are not actionable unless uttered directly, or with knowledge or notice that they will be acted on, to one to whom the speaker is bound by some relation of duty”. If the Auditors lacked a duty of care to the Factor precisely because they were not in privity with the Firm, then the words uttered directly to the Factor would never be actionable only because of the lack of privity. Cardozo’s rationale is circular and unconvincing.

C. The Restatement (Second) of Torts

“Section 552 imposes third-party liability on professionals who supply inaccurate information to their clients where the information is reasonably relied on by non-clients, such as creditors, banks, investors, and shareholders”. However, liability is limited by terms of the relationship and communications between the client and auditor. For example, assume a company retains the services of an audit firm to provide an opinion on its annual report. The audit firm knows that firms customarily use audited financial statements to obtain financing from creditors. Assume further that the audit is negligent and that the firm had used the audited financial statement to obtain a bank loan of $10 million. The audit firm is not liable to the bank for its negligent audit service because the client failed to notify the audit firm that the audited statements would be used to secure debt financing. Although section 552 does not require that the auditor have actual knowledge of particular third parties, third-party liability exists only if the client specified to the auditor that its services were required to obtain financing. The Restatement (Second) of Torts relaxes the consequences of the privity rule, but retains elements of the *Ultramares* doctrine.

D. Attack on the Citadel of Privity: The “foreseeability” test

The most aggressive expansion of the duty of auditors to third parties for certifying misleading financial statements is found in the decision of the New Jersey Supreme Court in *Rosenblum v. Touche Ross & Co.* In *Touche Ross*, the Supreme Court rejected the policy assumptions underlying Cardozo’s decision in *Ultramares*, recognised the evolving role of independent audits for external users, and noted, with justifiable irony, the contradictory rationale of *Ultramares* with Cardozo’s opinion in *MacPherson v. Buick Motor Co.*, where Cardozo had no problem imposing virtually unlimited liability upon a manufacturer of defective tangible goods for physical and economic loss, without concern for the “indeterminate class of persons” who may purchase the product after

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61 Id. at 183.
62 Jodi B. Scherl, supra n 2 at 273 citing §552(1).
63 Paraphrasing Jodi B. Scherl at 275.
64 93 N.J. 324 (1982).
entry into the stream of commerce.\textsuperscript{65} The Court rightly found an absence of principled distinction between liability for intangible defective “information products” and liability for tangible defective manufactured products.

In \textit{Touche Ross [Auditors]}, the “prominent accounting firm” audited the financial statements of a Massachusetts company, Giant Stores Corporation [Giant] during the fiscal years 1969 through 1972. Giant operated discount department stores and its common stock was publicly traded on the American Stock Exchange requiring SEC filings of the audited financial statements. Rosenblum [External Users] was a New Jersey company that operated retail catalogue showrooms and arts and crafts. In 1971, relying upon the audited financial statements of Giant, the External Users began to purchase shares in Giant in anticipation of the sale of their company to Giant. In 1972, the companies reached a merger agreement whereby Giant would acquire Rosenblum in exchange for a certain sum of common stock [up to a maximum of 86,075 shares]. During the merger negotiations, of which the Auditors were aware, Giant made a public offering of its stock in an amount of 360,000 shares. The prospectus contained the audited earnings report and balance sheets of Giant prepared by the Auditors for the four preceding years. Second, the Auditors subsequently began to prepare the relevant statements for year ending January 1972. The Auditors certified in every instance that the statement of earnings and balance sheets “presented fairly Giant’s financial position”.

In September 1973, less than one year after the 2 March 1972 merger, Giant filed for bankruptcy. The stock held by the External Users was worthless. The insolvency was due to a fraud committed by Giant by falsely recording assets it did not own and omitting substantial liabilities in the form of Accounts Payable. Thereafter, the External Users filed a complaint in New Jersey based in four counts: (1) negligence, (2) gross negligence, (3) fraud and (4) breach of warranty in law. Without recounting interesting, but for our purposes irrelevant procedural motions, the Supreme Court granted certification to review the parameters of auditor liability to external users of audited financial statements.\textsuperscript{66}

The first question addressed by the Court was whether, in the absence of privity, “an action for negligent misrepresentation may be maintained for economic loss against the provider of a service”. This action requires proof of four elements: a negligent misrepresentation, in the delivery of a service, resulting in economic loss, to a person not in privity with the service provider. While noting a split of authority within its own jurisdiction, the Supreme Court cut through the thicket of “demands for privity” and found that, when applied to auditors, that “within the outer limits fixed by the court as a matter of law, the reasonably foreseeable consequences of the negligent act define the duty and should be actionable”. Reviewing precedents that long ago discarded privity in the context of products’ liability cases based on negligence, the Court asked: “Why should a claim of negligent misrepresentation be barred in the absence of privity when no such limit is imposed where the plaintiff’s claim sounds in tort, but is based on

\textsuperscript{65} \textit{Macpherson v. Buick Motor Co.}, 217 N.Y. 382, 111 N.E. 1050 (1916) where Cardozo stated, “The manufacturer who sells the automobile to the retail dealer invites the dealer’s customers to use it. The invitation in the one case to determinate persons and in the other to an indeterminate class, but in each case it is equally plain, and in each case the consequences must be the same [liability for negligence, regardless of the lack of privity].”

\textsuperscript{66} The SEC, based upon a finding that \textit{Touche Ross} audits failed to meet the standards of the accounting profession, entered an order of censure. In addition, the audited financial statements filed with the SEC in connection with Giant’s 1971 public offering violated Section 11 of the 1933 Securities Exchange Act, though the N.J. Supreme Court did not have this issue before it.
liability for defects in products arising out of a negligent misrepresentation?” Ineluctably, the Court found that there was no justifiable reason to carve out an exception for auditors who place into the stream of commerce “information products” knowing that companies use audits for many legitimate business purposes, including the submission of financial statements to banks and other lenders. Invoking the language of the SEC, the Court reiterated, “the responsibility of a public accountant is not only to the client who pays his fee, but also to investors, creditors, and others who may rely on the financial statements which he certifies”. 67

The second question addressed by the Court was whether the expanded liability of the auditor “best served the public interest in the light of the role of the auditor in today’s economy”. The Court observed that the critical function of the auditor was to act as an “independent evaluator of the adequacy and fairness of financial statements issued by management to stockholders, creditors and others”, and not to place an imprimatur upon managements’ efforts to meet earnings expectations or to present financial results in a light favourable to its market objectives. Expanded liability would lead to the exercise of more care thoroughly consistent with the “conservatism” principle permeating financial accounting. The Court also considered, and rejected, the argument that imposing a duty upon accountants to third parties would lead to the “spectre of financial catastrophe, the argument currently being pressed by the auditing profession in the US and in the European Union, to again permit auditors to hide behind the shield of “privity” to escape the consequences of their own negligence.

Placing this “scare tactic” in perspective, the Court observed the instances in which auditors already are liable for defective audits, namely, Section 11 of the Securities Exchange Act, where a plaintiff need not prove scienter, negligence, or proximate cause of its loss; and Section 18 of the Securities Exchange Act of 1934 creating civil liability for any person causing a misleading statement to be made in any report filed with the SEC. Privity is no defence to actions brought under these statutes. The Supreme Court also remarked that, even under Ultramares, auditors are liable for fraud, regardless of privity. Though referring to a now out-dated 1976 study, the Court found that accountants had access to an insurance market to purchase professional malpractice insurance.

Crucial to the Court’s deference to the argument based upon the “spectre of financial catastrophe” was its observation that expansion of auditor liability to external users was not equivalent to an open door of unlimited liability. The Court stated, “The extent of financial exposure has built in limits”, stemming from the burden of proof any external user would have to bear to demonstrate that an auditor was liable for its economic losses, such as actual reliance upon the misleading financial statements and recovery subject to actual loss. The limitation is aptly captured by the phrase the “unbearable heaviness of the burden of proof”. Hence, the Auditors having inserted the audited financial statements into the stream of commerce are responsible for their careless misrepresentations to parties who justifiably relied upon the audited financial statements. That excludes any person, whether investor or debtor, who did not rely upon the audited financial statements to undertake a legitimate business transaction with the Company. Therefore, the distinction omits the ordinary investor who never reads financial statements, or if read, must prove that the decision to invest was based upon an understanding of the financial statements, a prospect hardly likely to develop.

67
a. The Legislative Reversal of Rosenblum

The New Jersey Legislature reversed the decision of the New Jersey Supreme Court under pressure from the powerful lobby of auditing firms, at that time the “Big Six”. The NJ Legislature enacted the “Accountant Liability Act” delineating the circumstances under which an accountant may be held liable for malpractice to a party other than the accountant’s client. \(^68\) However, even subject to the exacting standards of the “Accounting Liability Act”, designed to make it all but certain that audit firms are protected against any cause of action against their negligence, the decision in *Cast Art Industries, L.L.C. v. KPMG* is a fitting testament to the egregious conduct of auditors and their deplorable attempts to evade responsibility for malpractice.

The “Accountant Liability Act” consists of a three-part test that starts with language typifying legislation designed to curtail liability:

> “Notwithstanding the provisions of any other law, no accountant shall be liable for damages for negligence arising out of and in the course of rendering any professional service unless:

1. The claimant against the accountant was the accountant’s client; or
2. The accountant:
   a. Knew at the time of engagement by the client, or agreed with the client after the time of the engagement, that the professional accounting service rendered to the client would be made available to the claimant, who was specifically identified to the accountant in connection with a specified transaction made by the claimant;
   b. Knew at the time of the engagement by the client, or agreed with the client after the time of engagement, that the professional accounting service rendered to the client would be made available to the claimant, who was specifically identified to the accountant in connection with a specified transaction made by the claimant;
   c. Directly expressed to the claimant, by words or conduct, the accountant’s understanding of the claimant’s intended reliance to the professional accounting service”.

In spite of this legislative “straight jacket”, *Cast Art* prevailed against KPMG, except for the appropriate amount of damages. In a matter similar to *Touche Ross*, Cast Iron, a California corporation, relied upon financial statements prepared by KPMG, to merge with Papel Giftware, a New Jersey corporation. The circumstances speak for themselves as this excerpt from the decision demonstrates:

> “The record contains substantial evidence that KPMG knew not only that Papel’s audited financial statement would be made available to Cast Iron but also that Cast Iron would rely upon the statement and thus that issuance of the statement was a precondition of the proposed merger between Papel and Cast Iron going forward. The president of Cast Iron, Scott Sherman, testified that PNC Bank would not provide the financing required to complete the merger without an audited Papel financial statement. He also testified that there were

one or more conference calls between Papel’s management, Cast Iron’s management, and KPMG’s representative during which the need for the audited financial statements was discussed…. The evidence was sufficient to support the jury’s findings that KPMG had a duty of care to plaintiffs under each of the tests set forth in N.J.S.A. 2A: 53A-25(b)(2). 69

The New Jersey Supreme Court Found KPMG liable and reversed for a new trial only upon an accurate measure of damages. 70

E. The European Union: Capping Audit Liability

The European Union [EU] promulgated “Directive 2006/43/EC of the European Parliament and Council of 17 May 2006 on statutory audits and consolidated accounts” [Statutory Audit Directive]. The objective of the Directive was to establish minimum harmonisation requirements for statutory audits. Article 31 of that Directive required the Commission to report on the “impact of national liability rules for the carrying out of statutory audits on European capital markets and on the insurance conditions for statutory audits and audit firms”. 71 After the production of several notable documents, the Commission in 2008 issued Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms. 72 Article 2 of that Recommendation states, “The civil liability of statutory auditors and of audit firms arising from a breach of their professional duties should be limited except in cases of intentional breach of duties by the statutory auditor”. 73 The limitation is intended to apply against the company audited and any third party entitled under national law to bring a claim for compensation. Like the 2006 UK Companies Act, the

69 As one who served as Counsel, for 25 years, to the New Jersey Law Revision Commission years, whose mandate is set forth in N.J.S.A. 12-1, it is beyond cavil that the Accountant Liability Act was not written by the NJ Legislature, but by the lobby group for the large accounting firms. Law. In the author’s opinion, the NJ Legislature neither has the time nor the expertise to enact most legislation upon it merits. Take UCC Article 9 for example when the author and others appeared before the Senate Judiciary Committee. The NJ Legislature enacted the revised Article UCC Article 9 (Secured Transactions) in 1995. The enactment was based upon a short summary of the revision articulated before the Senate Judiciary Committee. There is no way that the extant Legislature at that time read, or could have possibly understood even if read, what they were enacting. In the event the author’s observation is incorrect, the author invites data to contradict his claim.

70 See BDO Seidman, LLP v. Banco Espírito Santo International, (D.C. App. Fla. 2010)(Opinion filed June 323, 2010) where BDO Seidman, the audit firm, was found liable by a jury for negligence and gross negligence in the audit of “Bankest” and awarded a verdict of $159 in compensatory damages and over $351 million in punitive damages. The District Court of Appeal reversed the verdict based upon technical defects in the lower court’s jury instructions. The decision in BDO Seidman, like its predecessors in Ultramares, Credit Alliance Corp. v. Arthur Andersen & Co, 483 N.E. 2d 110 (N.Y. 1985), and Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992, modified, 3 Cal. 4th 1049 (1992), illustrates how courts manipulate legal rules to limit or eliminate audit firm liability for negligently conducted audits.

71 Recital 1 of the “Commission Recommendation of 5 June 2008 concerning the limitation of civil liability of statutory audits and audit firms. L162/39.


73 One observer has remarked that the Recommendation presents “each country with a full carte blanche to independently choose a method of limitation.”Anna Samsonova, supra n 2 at 2.
Recommendation permits limitation of liability by contract between the audit firm and statutory auditor. A Recommendation is non-binding upon Member States.

The Article 31 mandate of the Statutory Audit Directive resulted in the 2006 publication of a Final Report entitled “Study on the Economic Impact of Auditors’ Liability Regimes (MARKT/2005/24/F)” addressed to the EC-DG Internal Market and Services and submitted by the London Economics in association with Professor Ralf Ewert, Goethe University, Frankfurt am Main, Germany. The Final Report of 381 pages comprises an in-depth study of the then 25 Member States’ statutory audit liability regimes and contains an analysis of the market for auditing services, particularly addressed to the consequences of unlimited liability for auditing networks based on catastrophic claims. While an extensive discussion of the Final Report is beyond the scope of this article, the key conclusions concisely state the results of the study and present the work of the authors in condensed format. The bottom line is that, without a liability cap for a flawed audit, the market confronts a loss of another Big-4 network and middle tier firms lack the mobility and resources to fill the void. The Final Report and the starting assumptions of Professor Talley’s article are virtually identical making the reports empirical data applicable to the United States audit environment.

The Big-4 networks dominate the market for statutory audit services within the EU. The high market concentration is due to the fact that large publicly listed firms hold the perception that, contrary to fact as specified in the Final Report, it is safer to retain the services of a well-known Big-4 firm to audit their financial statements. Secondarily, the Final Report argues that the Big-4 networks are the only institutions able to provide the range of services required by large, multinational firms. “This is because middle-tier firms face a number of barriers to entry into the market. Such barriers are reputation, capacity and breadth of their networks, and the exposure to unlimited liability in most Member States combined with very limited professional insurance availability.” The Final Report notes that, as of 2006, firms in the EU faced 11 claims ranging between €160 million to €785 million [or in the aggregate ranging between €1,760,000 and €8,635,000,000], and 5 claims in excess of €785 million each.

In addition, the Final Report notes the absence of adequate insurance on the market to cover the financial exposure of statutory audit firms, most notably the Big-4 networks. “The current level of commercial insurance is such that it would cover less than 5% of the larger claims some firms face nowadays in some EU Member States”. The large networks have established “captive” insurance companies [wholly owned insurance companies] funded by contributions from members of the umbrella organisation. Nevertheless, the Final Report maintains that the combination of commercial insurance and self-insurance through “captives” would be insufficient to cover a large claim. Remaining funds would come from partner income, thereby raising the question to what extent would partners be willing to take cuts to uphold the solvency of the firm. The Final report maintains that, in the event of a catastrophic claim against a Big-4 network, partners would leave the firm in droves. The implication is that, given a system of

74 Id. at 15, stating, “The study’s [The 2006 London Economics Study] findings suggested that the market for international audits was highly concentrated and effectively controlled by the ‘Big Four’ networks, which significantly reduced the likelihood of any middle-tier auditor becoming an alternative to the Big Four firms”.

75 Final Report [Commission Staff Working Document], supra n 70 at 23.

76 This conclusion naturally begs the question: leave the firm in droves to go where? It is doubtful that partners would leave to take positions in the middle tier-firms, and the existing large networks may not have a business need to take on any more partners. Taken to its logical result, the collapse of one large
unlimited liability and a shrinking market for insurance cover, the auditing industry, as presently constituted, cannot survive exposure to large claims for flawed audits. The Final Report concludes, “A limitation on auditor liability would reduce risk caused by potential catastrophic claims”. 77 The main question is to set the limit sufficiently high to induce care but sufficiently low to protect the Big-4 networks against failure.

The Commission Staff Working Document Accompanying the document to the Commission Recommendation Concerning The Limitation Of The Civil Liability Of Statutory Auditors And Audit Firms Impact Assessment {C(2008) 2274 final} {SEC(2008) 1974} provides an overview of the statutory audit industry and the effects of catastrophic claims. The information set forth in the “Commission Staff Working Document” relies substantially on the London Economics Final Report. Like the Final report, the Commission Staff Working Document notes the disparity between the demand and supply side; the inability of mid-tier firms to replace a Big-4 network to provide services to Multi-national companies; the lack of commercial insurance and the inadequacy of resources from “captive insurance companies” to survive a catastrophic claim; and the need to provide a liability shield for negligently prepared audited financial statements. Unlike the decisions in Ultramares and Caparo, the Commission Staff Working Document acknowledges that financial statements are principally prepared for third parties relying upon the statements to make investment or credit decisions, and accurate financial statements are essential for the integrity and efficiency of capital markets.

F. The UK Courts and Legislation

The seminal decision in the United Kingdom of auditor liability to external users of financial statements is found in Caparo Industries PLC v. Dickman et al. No less than five “Lords” expressed opinions that do not differ in methodology or rationale than that expressed by Cardozo, 70 years earlier, in Ultramares, thereby obviating any lengthy discussion of this 1990 opinion. Lord Bridge’s principal decision is nothing more than a British articulation of Cardozo’s 1931 opinion. The other four Lords agreed with the principal decision but insisted upon writing separate opinions amounting to a text of 32 pages, without adding novelty to the existing literature, except the parlance of privity as in the “neighbourhood of proximity”. 78

In the Companies Act 2006, the Government of the United Kingdom introduced a legal regime allowing companies and their shareholders to decide whether, and, subject to certain provisions, on what terms, to approve an agreement limiting the liability of a company’s auditor. 79 Sections 532 to 538 of the Companies Act 2006, which came into force on 6 April 2008, permits companies to limit the liability of their auditors by contract provided that shareholder approval is obtained. “The resulting arrangements are effective only to the extent that they are “fair and reasonable” in the particular circumstances”. 80 “A liability limitation agreement is defined in the Act as an agreement that purports to limit the amount of a liability owed to a company by its auditor in respect of any negligence, default, breach of duty or breach of trust occurring in the

network, under current liability schemes, might lead to the collapse of another large network, producing a domino effect, as partners would refuse to take income cuts.


78 Caparo Industries PLC v. Dickman et al. [1990] 2 AC 605.


80 Id. at 7.
course of the audit of accounts, for which the auditor may be responsible in relation to the company”. 81 Prior to amendment of the Companies Act of 2006, an auditor performing a negligent audit would be held liable to the company for all losses suffered as a result. An auditor was able to recover contributions from other persons responsible for the negligent audit, such as the fraudulent conduct of a company employee or negligence of another advisor to the firm. The amended Companies Act of 2006 allows the company and its auditor to limit liability by the institution of contract in any way that does not contradict the “fair and reasonable test”. “The Act does not specify the test to be applied to determine what is fair and reasonable, and in particular does not specify that what is fair and reasonable will depend solely on the auditor’s share of the responsibility”.

IV. Cracks in the Paradigms

A. Privity

The argument to restrict auditor liability based on “privity” is factually and conceptually unsound. It is beyond cavil that an audit firm has a contractual relationship with its client and lacks a contractual relationship with external users of audited financial statements. However, the “privity” argument is factually unsound because it conflicts with the commercial reality that the audit industry knows that financial statements are not made for the use or benefit of the client but for use by external users. Every accountant is taught that financial statements of publicly listed firms serve the interests of external users. While the client prepares the financial statements, the audit function is to ascertain the reliability and accuracy of the company’s financial statements precisely because external users rely upon them to make credit and investment decisions, and credit agencies, government regulators, and securities analysts use the statements to report information to the market. In addition, the privity doctrine is conceptually unsound. Claims against audit firms for defective work products do not sound in contract. Non-contractual obligations result from affirmative conduct that creates a foreseeable risk of harm to those who may be harmed by the conduct. 83 Rather the claims sound mainly in tort or statutory violation. Audit firms cannot “contract away” the commission of “torts”. Audit firms that have deviated from professional standards cannot hide behind the veil of contract to evade liability.

B. Capping Liability

The argument to restrict auditor liability based on inadequate availability of insurance in the market raises legitimate policy concerns but ultimately is not compelling. The argument is legitimate because the likely “deep pocket” to survive the collapse of a publicly listed company is the audit firm thereby raising the “spectre” of mass claims. Policy makers instruct that the vast majority of publicly listed firms use large accounting firm networks because their multi-national activities require coordination of financial statements prepared in multiple jurisdictions. However, the argument overlooks the fact that accounting and audit standards are converging into a uniform system of rules, making it easier to prepare documents based on cross-border activity. The argument also

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81 Id. at 11.
82 Id at 13.
fails to explain why the proposed protection is not extended to multi-national firms that, though not large accounting networks are faced with similar pragmatic problems and exposure to substantial liability stemming from violations of legal mandates. The fact that large accounting networks consist of separate partnerships, a business form that does not provide limited liability protection, is the business decision and assumption of a known risk by individual partnerships seeking profit maximisation. Some firms, such as E&Y, have opted for the Limited Liability Partnership organisational firm, and therefore the private assets of the partners are protected from judgments based on negligence.

Moreover, the argument rests on several additional predicates that do not “hold water”. Policymakers instruct that, if liability is not “capped”, partners of the large accounting networks, unwilling to risk their private capital, will leave the “networks” in droves. The question naturally arises: leave for where? Taking the statements of the policymakers at face value that partners mainly are interested in capital accumulation, the alternatives for partners seeking shelter from potential liability for flawed audits appear slim. The mid-tier firms may be unable to absorb the abrupt excessive and expensive supply of labour and the partners from “fancy firms” may deem mid-tier firms beneath their dignity. The claim that mid-tier firms cannot step up and take the place of a large failed network is not convincing. Policy makers instruct that significant barriers exist to market entry to the customer base served by the large accounting networks. Close reading of the texts, however, reveals that the most significant barriers are legal that can be removed instantly by legislative fiat. If the market served by the large accounting firms is lucrative [a reasonable assumption in a free market economy], then mid-tier firms through association, cooperation, or merger have the incentive and the ability to fill the lacuna, especially given the likelihood of virtually single international audit standards.

Furthermore, the most compelling argument against “capped liability” is that liability is difficult to establish. Audit firms are not held liable due to any or all mistakes, reasonable interpretations of accounting and audit standards, and the exercise of reasoned judgment in the audit process. The audit firm also is not required to provide an unqualified audit. Audit firms are held liable only if the injured party proves the elements of its claim. Even if that claim is negligence, the burden of proof is difficult to meet. The aggrieved party must establish the existence of a duty. In the event of external users, this element of the claim is likely to be nuanced and hard to sustain. Next, the party must demonstrate a breach of that duty, and the fact that the breach was the proximate cause of its economic loss, a difficult task. Finally, the party must delineate accurately its damages. A claim of fraud poses greater difficulty, as it requires proof of scienter. Any audit firm having fidelity to fundamental principles of accounting, such as materiality, conservatism, and knowledge of its legal obligations, is unlikely ever to face the spectre of “catastrophic claims”. The LBHI case is illustrative of this counter-argument: had E&Y informed LBHI to disclose in notes to the financial statements the size and nature of its Repo 105 and 106 transactions, and if LBHI refused, issue a qualified audit, E&Y would have an iron clad shield against liability. E&Y either had its head in the sand, or failed to adhere to the principle of conservatism, a known breach of professional standards.

It is sheer irony that the Big-4 claiming to recruit the brightest talent and “holding themselves out” as the best experts in the field are exactly the firms screaming the loudest for legal protection in the form of “capped liability”. If liability is capped, and if the Big-4 firms are essentially made judgment-proof, then the question arises: what is the value of an audited financial statement of a publicly listed company? Policy makers calling for protective legal measures are removing moral hazards and incentives for audit
firms to adhere to the highest ethical and legal standards to produce reliable and trustworthy audited financial statements that all parties concerned deem critical to capital market performance. The argument for “capped liability” is capable of obviating the function of audited financial statements, and therefore entirely misguided.

C. The Foreseeability Test

The “foreseeability” test is the most conceptually sound doctrine governing auditor liability. It seamlessly integrates the objectives of an audit with legal principles of non-contractual liability to third parties: conduct that creates a foreseeable risk of harm to that class of persons that may be harmed by the conduct. An audit firm knows that it is not the servant of the client but rather a provider of information to the capital market. The fact that the audit firm may not know the specific creditor or investor, or undertake direct communications with non-contractual third parties is a fact irrelevant to the enterprise and function of the audit firm. Analogical reasoning supports this conclusion. Contrary to Cardozo’s characterisation, audited financial statements are not equivalent to “words uttered”. Rather, they are the carefully crafted products of professional experts that charge clients for their services. Prior to the release of the audited financial statement into the stream of commerce, the lead partner of the audit must approve and sign the audited financial statement. The four stages of the audit process, combined with the opportunity to deliberate whether the audit adheres to professional standards and mandatory law further support a theory equivalent to “product liability” for “information products”, such as audited financial statements. The practical consequences would not differ from alternative legal theories of recovery: parties would have to show that the audit was “defective” and that the audit firm was responsible for the defect.

The thorny question that arises from holding audit firms liable to external users for flawed audited financial statements is how to limit the class of external users entitled to recover losses. Certain classes are obvious to include: creditors that relied upon the financial statements and, based on that reliance, extended credit to the company, including banks, insurance companies, and bond holders. Purchasers of securities relying upon the financial statements for the purpose of acquisition, such as the acquirers in Ultramares and Caparo, also present compelling case for inclusion. However, existing shareholders pose complex questions. Non-institutional shareholders rarely read the financial statements and filings of firms in which they hold stock. Therefore, individual shareholders, while victims of flawed audits, likely have not relied directly upon the data contained in financial statements. Since the claim does not sound in fraud, individual shareholders would have to prove reliance upon the flawed audited financial statements to recover against the audit firm.

Nevertheless, the “foreseeability” paradigm is dead. It is politically unacceptable as demonstrated by Professor Talley, the New Jersey Legislature, and Samsanova’s article depicting the “politicisation” in the European Union of the question of audit firm liability. Hence, while the “foreseeability” paradigm best fits the profession’s own standards and the logic of tort law development, policy considerations, such as market concentration, and the absence of insurance, have removed this option from serious consideration.
D. Restatement (Second) of Torts

Restatement §552 is a mollified version of the Ultramares doctrine. The decision is Bily v. Arthur Young & Co. aptly illustrates the incoherency of the Restatement approach. In denying liability to the Bank that relied upon the audited financial statements of Osborne Computer Corporation, the Court invoked the tired adage: “to make foreseeability of injury the determinative factor would be tantamount to imposing liability on any accountant who performed an audit for a company that defaulted on loans, became insolvent, or filed for bankruptcy and was unable to pay its creditors”. This statement is blatantly wrong. Liability is imposed only if the audit firm is negligent, grossly negligent, or reckless. An audit firm adhering to the five phases of the audit procedure, the applicable standards, whether GAAS or IFRS, is unlikely ever to be held liable for damages stemming from negligence.

Second, the court in Bily rested its decision upon arguably faulty assumptions. The Court stated, “[T]he auditor is at the client’s mercy with respect to what is contained in financial reports”. No such statement is farther from the truth, as demonstrated by Part I of this article. Second, in the event, the audit firm determined the client was recalcitrant and withholding information, the audit firm would have an obligation to terminate its relationship with the client or issue a qualified statement. The Bily Court even proposed that a non-contractual third-party, such as a bank, retain its own audit firm to verify the accuracy of the debtor’s financial statements. First, this measure leads to waste, renders the original audited financial statements virtually worthless, and presumes that the new “audit firm” would not be at the mercy of the client. No empirical evidence supports this questionable, if not preposterous, suggestion.

The Restatement (Second) of Torts test may not survive the Restatement (Third) of Torts under draft by the American Law Institute. The revision to the Restatement (Second), in its current version, comes close to adopting a “no duty” ruling for pecuniary loss caused by negligence unless specified and explicit conditions are met. Given the traditional origin of obligation in conduct capable of causing harm to a foreseeable class of persons, the “economic loss” provisions of the draft Restatement (Third) of Torts appears driven by policy considerations that reflect political agenda.

V. Lessons from LBHI and Two Normative Solutions

If the explanation contained in the Valukas Report detailing the use of Repo 105 and Repo 108 is taken as valid, it would appear that a case against E&Y based on audit liability is a “slam dunk”. First, E&Y served as LBHI auditors during the period 2000 and 2008, when the firm began its use of SFAS 140. Second, if the “Know Thy Client” obligation is taken seriously, then E&Y knew that LBHI reposed upon a high-risk business model requiring daily infusions of large sums of cash, reaching into the millions of dollars. Even a non-expert would question the origin of these borrowings and the ability to repay them. Third, off-balance sheet transactions are a “red flag” in the audit industry. The question arises: why E&Y did not investigate the nature, purpose, and objectives of LBHI’s off-balance sheet transactions based upon Repo 105 and 108. Fourth, SFAS 140 repo transactions require a “true sale” letter from a law firm; no US law firm would provide a letter thereby providing a reason for E&Y to examine and

investigate the use of SFAS 140 repos. Fifth, in 2007-2008, the pace and volume of Repo 105 and Repo 108 transactions dominated firm activity and E&Y would have to have had its head in the sand to miss the significance of these transactions. Sixth, E&Y was informed by an employee of the questionable practice of the off-balance sheet transactions, failed to report these borrowings to the independent audit committee of LBHI, and did not undertake an effective review of LBHI internal control procedures regarding its accounting practices as required by SARBOX.

The collapse of LBHI leaves E&Y in the position of being the surviving “deep pocket” for loss recovery if E&Y audit procedures were negligent. Based on the data contained in the Valukas Report, and assuming an absence of fraud, E&Y, under the federal paradigm, would encounter potential liability only if a Section 11 violation were applicable. But to succeed on the merits depends upon a nuanced interpretation of “scienter”. 86 Without additional information, under the non-contractual paradigms, except for the largely rejected “foreseeability test”, the privity doctrine and the Restatement (Second) of Torts approach are likely to provide an effective shield against cataclysmic liability. Disregarding forum shopping, New York and Delaware Law do not recognise the “foreseeability” test. Consequently, the probability that a legal regime would hold E&Y accountable to the “indeterminate class of persons” relying upon the audited financial statements of LBHI is insignificant. This result sets the framework for the two normative positions posited by this article.

a. Accountability to External Users for the Production of Misleading Audited Financial Statements

Support for holding audit firms liable for negligently audited financial statements is found in the economic analysis of law of tort law as formulated by Cooter and Ulen.87 The economic essence of tort law is its use of liability to internalise externalities created by high transaction costs. Externalities are harms that occur outside of private agreements. The economic purpose of tort law is to induce injurers and victims to

86 In his opinion, Judge Kaplan remarkably found, without supporting citation, that the “true sale” letter from Linklaters was not a “red flag”. His reason: “given that our legal system sprung from the English one, it would be odd indeed to conclude that the use of an opinion from a well-known U.K. based law firm on a question of common law – whether a true sale had occurred - calls into question the accuracy of the opinion’s conclusion”. In Re Lehman Brothers, supra n 11 at 72. Absent from this reasoning is the fact that the Linklaters opinion was addressed to the LBHI U.K. subsidiary and was applicable to transactions with counter-parties in Europe. VR, Vol. III, p 23. This reasoning is the worst sort of fact “cherry picking”. In Re Lehman Brothers, supra n 11 at 72. It also conflicts with the Valukas Report based on an interview with William Schlick, the lead E&Y audit partner. The VR states, “The Examiner interviewed Ernst & Young’s lead partner on the Lehman audit team, William Schlich, regarding Lehman’s Repo 105 program. According to Schlich, Ernst & Young had been aware of Lehman’s Repo 105 policy and transactions for many years”. VR, Vol. III, p 231. The Examiner also makes clear that E&Y simply relied upon LBHI’s decision that Repo 105 and Repo 108 complied with SFAS 140, without E&Y making any independent inquiry. Id. at 233-235. “Ernst & Young did not review the Linklaters letter, referenced in the Accounting Policy Manual”. Id. at 233. Judge Kaplan’s reply: “Nothing in SFAS 140 requires that the true sale at law opinion to be based on U.S. Law”. In Re Lehman Brothers, supra n 11 at 30. The Kaplan conclusion also conflicts with auditing standards to detect fraud. An incentive that the audit team must review is “financial pressures for either improved earnings or an improved balance sheet”. Rittenberg, Johnstone and Gramling, supra n 12 at 466.

87 Robert Cooter & Thomas Ulen, Economic Analysis of Law (Pearson 6th ed. 2011). The economic analysis of law of torts is not far from the Learned Hand model. The Learned Hand formulation is: (1) P = probability of the event happening, (2) L = gravity of harm, and (3) B= burden of precaution. When B<PL, then liability is imposed upon the party failing to take that precaution.
internalise the costs of harm that can occur from the failure to take care. When potential wrongdoers internalise the costs of harm that they cause, they have incentives to invest in safety at the efficient level. Harm in economic terms is a downward shift in the victim’s utility or profit function. These can be considered “goods”. An indifference curve can depict combinations of combinations of health and wealth that give, let’s say, Dylan, the same level of satisfaction.

The building blocks of the economic model of tort law are: (1) cost of harm, and (2) cost of avoiding harm. The probability of accident = $P$ decreases with increase in precaution $X$. $P = p(x)$ is a decreasing function of $x$.

Now, we must weave in harm (property/person). $A$ denotes the monetary value of the harm. $A \times P = \text{expected harm in monetary terms}$. Expected harm decreases as precaution increases. But precaution involves loss of time, money and convenience. Precaution can be quantified in monetary terms: $W$ is precaution cost. Assume $W$ is constant and does not change with amount of precaution, thus $W \times X = \text{total amount spent on precaution}$.

Graph: Expected social costs of accidents shown as sum of precaution costs and expected cost of harm:
If precaution is less than the efficient amount, then the marginal social cost of precaution is less than the marginal social benefit. When the marginal social cost of precaution is less than the marginal social benefit, efficiency requires taking more precaution. If precaution exceeds the efficient amount, then the marginal social cost of precaution exceeds the marginal social benefit. Efficiency requires taking less precaution. We add the costs of precaution and expected harm to obtain the expected social costs of accidents denoted as SC: $\text{SC} = wx + p(x)A$

In the above graph, the $\text{SC} = wx + p(x)A$ is U-shaped [although depicted here as a straight line]. The bottom of the U represents a value of x that is the level of precaution that minimises the expected social costs of the accident. $X^*$ is the socially efficient level of precaution or the efficient level of precaution. The cost of more precaution (marginal cost) equals the price per unit of w. More precaution reduces the expected cost of harm (marginal benefit): Reduction in expected cost of harm = Reduction in the probability of an accident denoted as $-p'(x^*)A$. Efficiency is achieved when: $w \text{ [marginal social cost]} = -p'(x^*)A \text{ [marginal social benefit]}$.

Though data is not available to quantify the cost of extra precaution that an auditor need undertake to assure that its audit conforms to professional standards, it is likely that the marginal social cost of precaution is less than the marginal social benefit. Efficiency therefore requires taking more precaution. This proposition accords with Richard Posner’s frequent use of the doctrine that the person in the best position to avoid the loss should be the party to bear the loss. The firm is the party in the best position to avoid the loss suffered by creditors and residual claimants. However, in the event of firm bankruptcy, the audit firm must be considered to be the party in the best position to have avoided the loss. The audit firm, unlike external users of financial information, have access to firm information, the ability to correspond with management and employees, the responsibility to evaluate the internal control system, the obligation to test management assertions, and, based upon this procedure, formulate an opinion. The logic of traditional tort law and its reformulation within the economic model provide sufficient policy reasons to pin liability upon audit firms for negligently introducing into the stream of commerce misleading financial statements and allow external users of misleading financial statements resulting from audit firm negligence to recover losses provided the elements of the cause of action are met.

b. No Duty Ruling or Capped Liability Option: Etiquette Requirement

If policy makers reject the logic of holding audit firms liable to external users of misleading financial statements, then the limited value of audited financial statements must be made clear by explicit language contained in the audit opinion. The audit opinion ought to contain language communicating that an audit cannot provide any assurance of the financial condition of a firm but only confirm whether the firm technically has complied with applicable accounting standards in the preparation of its statements. This alternative approach is consistent with the practice of firms placing a label or etiquette upon products that convey risks to users of those products. Informational products are no exception. It also would eliminate the “expectations gap” between the actual significance of audited financial statements and the illusory concept held by public as argued by the audit industry. The revised audit opinion statement would clarify to external users the limited value of audited financial statements and make
users aware of the risk of reliance. While this alternative appears to undercut the purpose of an independent audit and the policy of SARBOX, it best fits reality as audit firms maintain that external users have unrealistic expectations of the audit opinion. In short, an audited financial statement of a firm is to be used with knowledge of full risk of its flaws.

Conclusion

The weight of argument favours holding large accounting networks liable for the professional malpractice in the preparation and approval of audited financial statements inconsistent with industry standards and mandatory law. A corporation is nothing more than a complex set of financial data; hence, policy dictates that this data is free from imperfectly constructed financial statements. Limitations of liability are not unknown in the law, e.g., transport industries, benefit from liability limitations. However, legal systems generally have not extended liability limitations by statute to other industries. Rather, parties use the institution of contract to impose limitations of liability, an approach unavailable to audit firms exposed to liability to third parties when the client enters bankruptcy. The dearth of insurance constitutes the strongest argument for capping liability of audit firms that have committed acts of professional malpractice. Nevertheless, legal rules ought to provide incentives to achieve efficient results. The party in the best position to avoid the loss arising from flawed audited financial statements is the audit firm. Hence, legal rules should hold to account the large accounting networks for losses proximately caused by their professional malpractice. Regrettably, due to market concentration of the audit networks and the dearth of private market insurance, this option is politically unacceptable. Alternatively, policy makers must require audit firms to disclose to the public the inability of an auditor to assure that financial statements depict a fair and accurate financial photograph of a firm. The public then lends or invests at their risk. The current claim that the audit is “only an opinion” falls short of the required warning.