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Accountants' Liability to Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle

J. H. Leibman

Anne Kelly
Butler University, akelly@butler.edu

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Introduction

In Ernst and Ernst v. Hochfelder,(n1) the Supreme Court held that section 10(b) of the Securities Exchange Act of 1934(n2) was inapplicable for holding accountants liable for mere negligence. Therefore, in the absence of scienter -- a provable "intent to deceive, manipulate, or defraud"(n3) -- plaintiffs are required to look to state law for remedies when they have relied to their detriment on negligently audited financial statements.(n4)

But in the state arena, injured investors, creditors, and other third party plaintiffs are confronted by several judicially adopted approaches that restrict in varying degrees parties not in contract privily with a company's auditors from recovering damages from those auditors caused at least in part by negligent auditing. In a number of jurisdictions injured parties have found that they generally have no standing to sue accountants they have not themselves engaged, except in those cases where the accountants had prior actual knowledge of the third parties' identity and their provable reliance(n5) on the financial information.(n6) This class of third parties -- generally made up of creditors,(n7) guarantors,(n8) and investors(n9) -- are subject to the famous rule from Ultramares v. Touche,(n10) in which Justice Cardozo expressed deep concern for the future of the developing public accounting profession,(n11) were he to rule, consistent with his opinion in McPherson v. Buick Motor Car Co.,(n12) that accountants must be prepared to compensate all foreseeable victims whose economic losses are proximately caused by the accountants' negligent statements.(n13) This privily/near privily rule is generally followed strictly in those jurisdictions that have adopted Ultramares.(n14)

Another group of states, however, follow the broader limitation of Section 552 of the Restatement (Second) of Torts,(n15) which does not require the members of the "limited group of persons for whose benefit and guidance"(n16) the accountant intends to supply the information to be individually identified.(n17) This "limited group" is sometimes referred to as a foreseen class of users.(n18)

An even more liberal approach follows Biakanja v. Irving,(n19) which provided several factors for determining whether a third party beneficiary under a will could maintain suit against a negligent notary in the absence of privily. Applied to auditors' liability the one court adopting this "balancing test" approach has held that the trier of fact is not precluded from finding liability in instances where the third parties are neither known to the auditor, as required by Ultramares, nor are in a class sufficiently foreseen to satisfy the Restatement.(n20) The operative balancing factors turn on both the foreseeability of the plaintiff and the closeness of the connection between the auditor's negligence and the harm to the plaintiff.(n21)

In the 1980s several state courts virtually eliminated the privily barrier in auditors' cases by judicially adopting some form of the general negligence foreseeability rule, holding that accountants are potentially liable to any third party who reasonably might be expected to rely on the audited financial statements.(n22) This latest development has dramatically increased the exposure of auditors to liability for negligent misrepresentation.(n23) Presumably, the auditor could be responsible for compensatory damages equal to the total losses suffered by creditors, or even guarantors of the creditors, when debtors become insolvent and are unable to meet contractual obligations. In addition, such liability could extend to capital losses incurred by equity investors who have detrimentally relied on the accuracy of audited financial statements when assessing the risk of investment.(n24) And because auditors' liability to third parties sounds in tort, punitive damages are also a distinct possibility.(n25)

Until the first of these foreseeable plaintiff cases, H. Rosenblum v. Adler,(n26) accounting firms could assume that negligent conduct carried with it limited consequences. By greatly expanding the class of potential plaintiffs, Adler ushered in a new, far more dangerous environment for those in the business of assessing financial information.

In this article, the authors explore the implications to the accounting profession and the business world of moving from a sheltered, insulated position under Ultramares to a highly exposed one introduced by Adler. It is possible that the foreseeability rule for auditors' liability will become increasingly pervasive, inasmuch as the savings and loan debacle will make it increasingly clear to the public, and hence to the courts, that the failure to provide accurate financial information can have catastrophic effect on the national economy.(n27)

Even under the Restatement formulation, one can anticipate that third party creditors, investors, and guarantors will increasingly insist that companies seeking funds must advise their auditors that the audit opinions are being used as evidence of their client's financial health, which would trigger exposure of the auditors to third party liability. We are concerned, however, that imposing unlimited liability on certified public accounting firms will consistently place huge, unfair, and economically inefficient burdens on relatively minor participants in negligently -- or even fraudulently -- operated enterprises.(n28) In the absence of a privily rule some other limiting principle would appear appropriate because accountants are not well positioned to serve as guarantors of the soundness of the business enterprises they audit.(n29) This article is a search for such a viable, limiting principle.

We begin with a short history of the American accounting profession in order to explain how the structural situation arose in which accountants compete for auditing fees and other revenues from parties whose operations the accountants must then examine with detachment, objectivity, and independence. In Part II we compare the American system with schemes used in other countries.

In the next part, we consider apportionment of damages as a limiting principle for auditors' negligence liability. Because the typical scenarios in which the auditor is joined as a defendant -- or is sued separately -- often involve an insolvent client, we discuss the effect of joint and several liability rules, with or without contribution, on comparative fault awards. We conclude that a regime of reasonable foreseeability under comparative fault and comparative contribution principles-a regime that permits comparison of all kinds and degrees of fault, that includes negligent misrepresentation claims, and is subject to a proportional several only rule -- is the fairest and most economically efficient limiting principle for governing auditor liability to third parties for negligence.

Following the damage apportionment discussion we briefly consider several other ways in which the liability of negligent accountants might be limited without compromising economic efficiency or corrective justice. In this part we also discuss the possibilities of restructuring the accounting profession to reduce the inherent conflict of interest pressures that flow from the competition among accounting firms to obtain auditing and consulting fees from clients whose statements the accountants then must audit. We conclude that some of these proposals have merit but are unlikely to be adopted in the United States.

A SHORT HISTORY OF MODERN AMERICAN ACCOUNTING

The modern American accounting profession emerged as a reaction to the abuses of nineteenth century laissez-faire-based economic policies by unscrupulous promoters and financiers.(n30) The need to channel capital into credit markets in the early 1900s dictated that the public's resulting mistrust of bankers and securities manipulators would have to be allayed by subjecting internal corporate affairs to greater public exposure.(n31) It is not surprising, therefore, that the movement to provide that exposure was advanced by the leaders of the New York Stock Exchange.(n32) At the same time, however, the essential principles of classical economics, which emphasized unfettered competition, remained dominant in financial circles, so that the option of direct federal regulation to control corruption and fraud was resisted.(n33) Thus, the essential role of accountancy to provide the necessary financial publicity was established.

The expertise and independence of American accountants became widely recognized when they played a vital role in rooting out government corruption and improving government efficiency at the turn of the twentieth century.(n34) Accountants also played an important part in implementing the graduated income tax, an event that greatly increased the need for accounting services.(n35) Although the income tax was generally considered a "progressive" reform, accountants continued to ally themselves with business interests and business thinking,(n36) rather than the various progressive social philosophies that were surfacing at the time.(n37) Nevertheless, it was the social reform movement that gave birth to a recognized accounting profession.(n38) Although the profession was marked by an institutional framework built around state societies,(n39) eventually, national organizations were formed to establish standards for entry and practice.(n40)

In the 1920s, there was little demand from government for the audited financial statements of private corporations.(n41) Accountants, therefore, focused on providing services for business clients other than auditing. These included budgeting, establishing standard cost systems, and for many small clients, even furnishing staff for internal accounting control.(n42) Providing these management services plus serving as advocates in tax matters drew accounting firms ever more closely within the orbit of their clients' vital interests.(n43) As Previts and Merino explain, "Early debates about the CPA's role and obligation to both the client and the public became infrequent."(n44) This increasing congruence of the interests of the accounting profession and corporate America was reinforced by the philosophy of Treasury Secretary Andrew Mellon (1921-30), who supported maximization of control over the country's resources by the wealthy, arguing, in effect, that trickle-down economics would eventually maximize wealth for all. Under such a regime, "[t]he social role of accountants came to be seen as minimization of taxes."(n45)

After the stock market crash in 1929, when disillusionment with the stewardship of the economy by the business class became widespread, the accounting profession still did not question the business advocate role it had earlier adopted. "With tax work and management services being the main avenues of survival for many accountants, the audit function became [even] less important. Many new practitioners remained oblivious to, if not totally unaware of, any obligation to third parties."(n46)

Judicial development of theories of legal liability for accountants tended to reinforce the complacency of the profession. Although a 1905 court decision held that accountants must exercise reasonable care,(n47) this negligence standard was applied leniently. "`Accountants could assume the honesty of management and could rely on their representations.'"(n48) In Craig v. Anyon,(n49) the court recognized the defense of contributory negligence that could be raised by a negligent auditor whenever the client conducted its business in a negligent manner.(n50) Finally, in 1931, Ultramares v. Touche(n51) was decided. The court, while holding that accountants could be held liable to third parties for gross negligence amounting to fraud,(n52) also held that unidentified, yet foreseeable third party victims should not be permitted to maintain actions against auditors for ordinary negligence.(n53)

There appears to have been little early recognition that the profession's independence might be compromised by the direct accountant-client relationship. Until the 1929 crash, investors and creditors appeared reasonably satisfied with the corporate disclosures of financial information certified by CPA firms.(n54) The institutional framework had become so established that, even after the crash, reformers ignored the structure of the accountant-client relationship, focusing instead on direct government regulation to set stringent requirements that independent audits provide complete disclosure to the public by large corporations.(n55) The 1933 and 1934 federal securities acts spelled out the necessary information, and the New York Stock Exchange came around to supporting the necessity for independent audits of listed companies by CPA firms.(n56)

In the half century following the crash, the role of public accountant as private entrepreneur appeared to have been accepted without serious challenge. Although isolated major bankruptcies surprised investors and creditors from time to time, the financial community felt generally secure with the federal regulatory system (for public stock issues) and its disclosure requirements. Also, huge investment funds were acquiring ever greater percentages of American corporate equity; presumably, the sophisticated, professional managers of those funds could be relied on to serve as independent watchdogs with respect to the accuracy of the financial information released by major corporations. At the same time, accounting firms were becoming larger, more professional, and presumably more protective of their reputations, thus creating an incentive for them to produce high-quality audits.(n57)

But with the growth of the profession came increased competition. The need to retain and attract major clients created pressures for the auditor to view its client's accounting treatments through the eyes of the client whenever Generally Accepted Accounting Principles (GAAP)(n58) would permit such accommodation. Although there is nothing new about giving clients the benefit of the doubt in gray areas, the consequences of such decisions became far greater as the financial strength of American corporate giants became less secure in a world of intense global competition, corporate raiding, leveraged buyouts, rapidly changing technologies, and heavy dependence on foreign energy sources.(n59)

Beginning in the late 1970s, the need for more reliable financial information by the investment community became evident. In its Professional Standards, specifically the Code of Professional Ethics, the AICPA stated:

The Ethical Code of the American Institute [of Certified Public Accountants] emphasizes the profession's responsibility to the public, a responsibility that has grown as the number of investors has grown, as the relationship between corporate managers and stockholders has become more impersonal, and as government increasingly relies on accounting information.(n60)

In 1984, Chief Justice Burger likewise reminded the accounting profession of its public role.

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 corporation's creditors and stockholders, as well as to the investing public .... To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.(n61)

The California Court of Appeals, in International Mortgage Company v. John P. Butler Accountancy Corp.,(n62) relied on both of the foregoing "public-duty" quotations in holding that lack of privily would no longer insulate California accountants from common law negligence suits brought by foreseeable third party users of financial reports.(n63) The adoption of the Adler rule by an appellate court in America's largest jurisdiction seemed to announce that this last citadel of privily protecting auditors under negligence law was falling at last.

In addition to the heightened attention given to auditors' duties to third parties by the courts, there has also been increased interest in this problem expressed by the SEC, the Congress, and the internal regulatory mechanisms of the accounting profession itself. In its Accounting Series Release (ASR) no. 4 in 1938, the SEC established the presumption that financial statements that were prepared without substantial authoritative support would be deemed misleading.(n64) In 1973 the SEC indicated that practices promulgated by the profession's Financial Accounting Standards Board (FASB) would be deemed authoritative and standards followed that were contrary to FASB would not be.(n65) In the 1970s the SEC also disciplined a number of accounting firms having "broad public responsibilities, inferring that these firms had not adequately regarded their professional responsibility."(n66)

The Congress has twice in recent years held extensive hearings on the public responsibilities of the accounting profession and its ability to regulate itself. In the Ninety-fifth Congress, Congressman Moss and Senator Metcalf permitted critics of the profession to voice their concerns, while providing representatives of the profession an opportunity to respond.(n67) The Moss-Metcalf hearings focused on the profession's ability to detect management fraud and its effectiveness in disclosing bribes to foreign officials, conduct later forbidden by the Foreign Corrupt Practices Act of 1977.(n68) The staff report of the Metcalf Committee went further, however, voicing concern that there was insufficient independence being maintained between large publicly-held companies and their auditors.(n69) Critics have traced part of this concern to the accounting profession's aggressive marketing of management advisory services (MAS) to their audit clients.(n70) There appears to have been little or no early resistance in the United States to the proposition that accountants could serve as advisers to and advocates for their clients while at the same time acting as their independent auditors.(n71)

A collateral issue raised by critics of accountants performing nonaudit functions is whether accountants can "objectively review their own advisory service work in a client operation."(n72) Still a further complication is the practice of accounting firms placing former employees with clients as part of their placement services.(n73) Yet another dubious practice that has recently come to the public's attention is auditors' receiving favorable loans from client banks.(n74) The professional ethics executive committee of the American Institute of Certified Public Accountants (AICPA) has proposed that all such loans be banned.(n75)

According to one critic of the accounting profession, the Metcalf-Moss hearings were largely ignored by the press and thus little demand for structural reform resulted from them.(n76) This was in contrast to the extensive coverage of later hearings conducted by a subcommittee of the House Energy and Commerce Committee under the chairmanship of Representative John D. Dingell (hereinafter Dingell Committee).(n77) The main purpose of the Dingell investigation was to determine whether the quality control structure of the accounting profession was in place and operating effectively.

In particular, the committee challenged the scope of auditors' responsibilities, the effectiveness of the profession's self-regulation program, and the potential conflict of interest inherent in the client-auditor relationship. During the year-and-a-half of hearings, the Dingell Committee heard testimony from the AICPA,(n78) government agencies,(n79) major accounting firms,(n80) academicians,(n81) and many others. The ultimate outcome was HR 4886,(n82) co-sponsored by Representatives Dingell and Wyden, which called for, among other things, extensive expansion of the scope of auditors' responsibilities. The bill was effectively resisted by the accounting profession and the SEC ostensibly because it made the auditor responsible for detecting and reporting illegal acts to parties outside the client's organization.(n83) This requirement went far beyond what was required then and now.

This congressional interest was arguably responsible for much of the self-regulatory activity undertaken by the accounting profession in recent years. The AICPA expanded its board of directors to include three members from the general public, and the profession through the Financial Accounting Foundation eliminated the requirement that there be a majority of practicing CPAs on the FASB(n84) and established that proposed FASB standards could be adopted by a simple majority.(n85) Several other organizational changes were made, and the profession also undertook "a candid peer review program designed to provide a vehicle for constructive interpractice criticism in the United States and in overseas affiliates as well."(n86)

From the perspective of 1985, critic Robert Chatov, referring to foreign bribes by American businesses, wrote: "The fact remained that outside auditors had failed to uncover the criminal activity rife among many of the largest U.S. corporations. Today, the events under scrutiny . . . have been termed `audit failures' involving major business firms and banks."(n87) In a scathing editorial, Chatov took the American auditor-client structure to task. He summed up his position in testimony before the Dingell Committee as follows:

If one were starting from point zero today to create the most assuredly independent auditing system you could think of, I think it would be judged madness to invent a system where the one to be audited hired the auditor, bargained with the auditor as to the size of the fee, was permitted to purchase other management services from the auditor, and where the auditor in turn had the prime responsibility for setting the rules, and for enforcing them and applying sanctions against themselves. The idea is ridiculous on its face, and yet, that's the system we have in the United states.(n88)

After despairing of any hope of effective self-regulation, Chatov quotes his testimony before the Dingell Committee on what should now be done:

The auditing function should be defined in terms of what it can do, and the process itself ought to be changed so that the auditor is truly independent, which means that auditors ought to be assigned and rotated by the SEC, fees should be standardized, and no other business contacts ought to be permitted between the auditor and the audited so that conflicts of interests simply are structurally eliminated and the relation between auditor and client is no longer suspect.(n89)

In response to the notion that auditors should be rotated more frequently, the accounting profession has replied that effective auditing requires time to learn the client's business, and time is also necessary for establishing the relationship of trust required for securing client cooperation in reporting the whole financial truth.(n90)

The authors believe that the critics of the current auditor-client structure have highly persuasive arguments on their side. However, we doubt that radical structural change is in the cards, given that the well established accounting profession is certain to be implacably opposed. We will have more to say on the structural reform issue in our section on "other limiting principles."(n91)

AUDITING PRACTICES OF SELECTED FOREIGN COUNTRIES

The potential structural conflict is not unique to the United States, but it is dealt with in a variety of ways in other countries. Four countries were selected for investigation using four major criteria: (1) advanced economic development; (2) a fairly extensive history of the audit function; (3) information availability; and (4) differences from the U.S. structure. The countries selected were the United Kingdom, France, Japan, and Canada. In the structural reform section of this article, we recommend that several of the foreign practices be implemented in the United States.(n92)

United Kingdom

The Companies Act of 1948 outlined the professional qualifications required by auditors of joint stock companies in which limited liability exists (much like the U.S. corporate form).(n93) The Companies Acts of 1967 and 1976 effectively reinforced the 1948 Act.(n94) The Companies Acts require that "statutory" audits be performed for every limited liability company by a professional auditor. The Acts define "certain areas upon which the auditor is expected to express an opinion."(n95) Auditors may also perform "private" audits on behalf of an interested party such as a sole proprietorship or partnership where no statutory obligation exists. These audits may be defined as "widely or narrowly as the parties involved desire."(n96)

In the United Kingdom (U.K.), like the U.S., the preparation of the company's financial statements is the responsibility of management. The board of directors is responsible for ensuring that the "company keeps proper accounting records and that its annual financial statements give a true and fair view of the company's state of affairs"(n97) and profitability. However, unlike the United States, the statutory auditor in the U.K. is not permitted to perform "accountancy, taxation, or management consulting activities [for the client] while employed [by it] as an auditor, since these [services] fall outside the scope of his audit."(n98)

In a statutory audit, the auditor is engaged by the shareholders in order to protect their interests; therefore, although the contract of engagement is with the company's management, the auditor does not necessarily operate in the best interests of management or the board of directors. Hence, professional independence is crucial.

Some audit responsibilities exist whether the audit is statutory or private. The auditor has some responsibility for detecting errors and fraud but the duty is ill-defined.

If the inaccuracy of a set of accounts is linked to a well disguised fraudulent scheme then it seems particularly likely that normal audit procedures may fail to detect it. The extent to which an auditor would be responsible to detect fraud is uncertain, both because the law can give little guidance as to the precise circumstances in which an auditor should be able to discover a fraud, and because the law is unclear. It would seem that the auditor does not have to be suspicious, but if he encounters anything calculated to excite suspicion, he should probe it to the bottom.(n99)

To this extent, the situation is quite similar to that in the United States; however, the British accounting organization, CCAB, has published a draft of an Auditing Guideline entitled "The auditor's responsibility for detecting and reporting fraud and other illegal acts."(n100) Such a guideline if it were to become an actual standard would tend to reduce ex ante the gap between what the accounting profession believes is the scope of its duty to detect fraud and what the judicial profession is likely to assess as its duty of care ex post.(n101) In the United States, the accounting profession has declined to adopt specific fraud detection standards.(n102)

The auditor also has particular responsibilities for statutory audits. Under the Companies Act of 1948, the auditor must express his view regarding: (1) whether the balance sheet gives a true and fair view of the state of the company's affairs at that date; (2) whether the profit/loss account gives a true and fair view of the profit or loss for the year; and (3) whether the accounts have been properly prepared in accordance with the provisions of the Companies Acts.(n103) In addition, the auditor must indicate by exception only, those areas where the company has not met its statutory requirements such as: (1) whether proper accounting records have been maintained by the company; (2) whether proper returns have been received from branches where the auditor does not visit; (3) whether the financial statements agree with the accounting records; and (4) whether the auditor has received all information and explanations necessary.(n104) In contrast, because there are only private audits in the United States, the auditor is simply required to attest to the fairness of the client's financial statements in all material respects, unless SEC requirements mandate specific additional disclosures.

With respect to auditor's liability in tort to third parties for negligent misstatement, the situation is not entirely clear. Although reasonable foreseeability language does appear in the cases, various forms of a "proximity" (privily/near privity/foreseeability) test are also called for.(n105)

France

France has a high degree of government influence in the handling of accounting and auditing matters. In 1947, Le Plan Comptable General (National Uniform Chart of Accounts) was issued and detailed the types of balance sheet and income statement accounts that may be used as well as model financial statements.(n106) This standardization plan was originally mandated to create uniformity in the accounting of the country's nationalized industries such as iron, coal, steel, and railways as well as the "few largest publicly held companies."(n107) Successive government acts extended the plan to many publicly and privately-held companies and it currently is mandatory for all reporting entities and industries in France.(n108)

A statutory (or legal) audit has been required for over one hundred years of all societes anonymes (stock corporations) with share capital in excess of 300,000 French francs. These companies must have their accounts examined by one or more commissaires aux comptes (statutory auditors).(n109) These auditors are chosen by the company's shareholders for a six-year term; however, this term is revocable. Statutory auditors are also required to "certify whether accounts of the firm -- and all reports and financial statements addressed to shareholders by management and the board of directors -- meet the standards of `regularite' and `sincerite.'"(n110) According to the 1982 version of the Plan Comptable General, regularite means conformity with existing rules and regulations, while sincerite means the good-faith application of existing rules and regulations by those responsible for the company's accounts.(n111) In addition to these statutory responsibilities to shareholders, the auditor is supposed to ensure that the governmental regulations and tax laws are not violated.

These responsibilities go well beyond those of auditors in the United States. However, like the United States, French auditors are required to be independent of the board of directors of the client company. Unlike the U.S. practice of negotiating fees based on time spent on the audit engagement, a 1966 French law established a fee schedule for auditors performing the attest function whereby auditing fees are established using a sliding scale based on a formula related to the size of the audited firm.(n112) Nevertheless, a commissaire may ask the client to pay more than the legal fee; however, the client is not required to do so. In addition, auditors are required to certify to "the truth and fairness of accounts and financial statements examined."(n113) This law further provides that only individuals whose names appear on the official list of commissaires aux comptes may perform statutory audits.

There are specific prohibitions related to a statutory auditor or relatives of the statutory auditor. These prohibitions include (1) auditing a company where any special benefits from the company are derived; (2) holding any type of management position; and (3) serving on the board of directors of the company being audited or any of its subsidiaries.(n114) Furthermore, auditors are prohibited from performing management consulting, tax consulting, or general accounting services for their audit clienst.(n115) The restriction is extended further to individuals and their spouses who function as part of management or the board of directors of an organization in which the audited company owns ten percent.(n116) These restrictions exist for at least a five-year period following the audit.(n117)

Statutory auditors have no responsibility for detecting fraud except that they are legally responsible to their client and to third parties "for damages suffered due to the auditor's fault or negligence."(n118) French law requires commissaires to carry liability insurance in an amount specified by the government. Furthermore, the statutory auditor is required by law to report to the Public Prosecutor any criminal act committed by the company's board of directors of which he becomes aware.(n119) A similar requirement was introduced during the Dingell Committee Hearings in the United States,(n120) and was incorporated in its bill, H.R. 4886.(n121) The bill was not enacted.

Japan

The Commercial Law Code enacted in 1890 governs the organization of business enterprises and is administered by the Ministry of Justice.(n122) This Code specifies that audits of companies must be performed by statutory auditors who are responsible for attesting to the directors' functions as well as to the fairness of the financial statements. Statutory auditors must report their opinions on the financial statements which are submitted in a general meeting of shareholders. These statutory auditors may be professional accountants or independent auditors.(n123)

In the early 1970s, as a direct result of manipulation of the financial statements of companies that went bankrupt in the 1960s, a new Law for Special Measures under the Commercial Law Code as to Auditing was enacted.(n124) This law specified that stock corporations with capital over 500 million yen or with liabilities over 20 billion yen must be audited not only by a statutory auditor but also by an independent auditor who is either a CPA or a professional audit corporation.(n125) The statutory and the independent auditors must be approved by the shareholders.

As in the U.S., Japanese auditors are responsible for detecting "errors, fraud, or omissions that would cause a material difference in the financial statements."(n126) Furthermore, under the Law for Special Measures, if an independent auditor detects an unfair act by the directors, a violation of any law or regulation, or a breach of any bylaw of the corporation being audited, the auditor must report this matter to the statutory auditor.(n127) This goes well beyond the U.S. standard.(n128)

According to the Commercial Law Code, the auditor has a legal liability to clients and third parties. With respect to third parties, "if there is damage because of materially false items in the audit report, the auditor shall compensate for the damage, unless proof exists that his duties were performed with due professional care."(n129)

In addition to auditing, a CPA can perform other services including the preparation of financial statements, the performance of research and development, consultation on financial affairs, as well as tax and management consulting services. However, the CPA is prohibited from performing tax and management consulting services for their audit clients.(n130) This again is quite different from U.S. standards.(n131)

Canada

In Canada, as in the U.S., the purpose of an audit is for an independent auditor to express an opinion on the fairness of presentation of the company's annual financial statements prepared by the company's management.(n132) Corporate legislation requires that the shareholders appoint the auditor(n133) and that the auditor provide the audited financial statements to the shareholders within six months of the company's year-end.(n134) Audited financial statements may also be required by various creditors.

According to the Canadian Institute of Chartered Accountants' (CICA) Handbook,(n135) which outlines the codified generally accepted auditing standards, it is assumed that material errors and frauds will be discovered if Canadian GAAS is followed. However, it also states that an audit examination may not reveal all material errors and frauds inasmuch as the prevention and detection of errors and fraud rest with management and the auditor has no separate or additional responsibility for their detection.(n136)

The legal liability of auditors to shareholders of the client company for negligence is determined through the incorporation instrument.(n137) However, the auditors' legal liability to third parties for negligence was established through legal precedent in the 1976 case of Haig vs. Bamford.(n138) In Haig, the auditor was found liable to a limited class of third parties because the auditor had actual knowledge that this limited class would be relying on the audited financial statements.(n139)

The Criminal Code of Canada additionally prohibits an auditor from attesting to the fairness of a company's financial statements when the auditor knows they include negligent misrepresentations. "The liability of an auditor to shareholders of the client and to third parties in circumstances when the auditor is judged guilty of such activities appears to be absolute."(n140)

Canadian public accountants may perform an array of services beyond attesting services including the preparation of special reports, prospectuses, unaudited financial statements in which the level of assurance provided is less than that of an audit, unaudited interim financial statements, supplementary information associated with the financial statements, and forecasts.(n141) In addition, public accountants may also perform tax and management consulting services. Auditors may perform any or all of these services concurrently as long as they do not compromise their independence.(n142) But, as in the U.S., the independence of the public accountant would be impaired if the auditor functioned in any capacity as an employee or if the auditor had a stock ownership interest in the client company.(n143)

With respect to constraints on the accounting profession designed to ameliorate conflict of interest problems, Canada would appear to be most similar to the United States in prescribing few legal restrictions on entrepreneurial activity, while France is clearly the most restrictive. An interesting aspect of the French system is the uniform system of accounts requirement. The authors of one book find that:

The main advantage of the uniform plan is that it facilitates and permits better government decision making because all firms covered by the plan must follow identical procedures and formats for accounting reports. Thus interindustry and intraindustry comparisons are easier to make, and strengths and weaknesses, opportunities and bottlenecks are easier to identify. Once identified, the government can change the plan or change the inducements and more readily observe the impact of such changes.(n144)

Although American observers might see little advantage in a program designed to facilitate governmental intervention in individual corporate affairs, and might argue that such standardization restricts management judgments as to what accounting treatments are most appropriate for specific organizations, the French scheme would certainly shorten the learning curve for both auditors and outside users of the financial information.

APPORTIONMENT OF DAMAGES AS A LIMITING PRINCIPLE

As noted elsewhere in this article, structural reform of the auditor-client relationship is unlikely. Thus, the courts may be called upon to define better the role of accountants in covering the damages caused by their clients and themselves. In this part of the article we examine what we believe to be the soundest approach to allocating the risks associated with the negligent auditing of financial information. We will show that the fairest and most economically efficient rule is to limit tort damages in proportion to the tortfeasor's culpability.

In the simplest case, a negligent actor is responsible for all the legally cognizable harm she proximately causes. Yet even the concept of proximate cause represents a fundamental dissatisfaction with the notion of unlimited tort liability. In Ryan v. New York Central Railroad Co.,(n145) the court was concerned that the defendant railroad would be unable to bear the costs of a spark-caused fire that had spread beyond one adjacent building. It held, therefore, that damage to successive properties was not legally caused by the defendant's negligence.(n146)

That tort liability might prove ruinously heavy has always been an important factor in the administration of negligence doctrine.(n147) Unhappily, for most of the history of the American negligence regime, liability limiting defenses and doctrines in cases of indivisible injuries have been "all-or-nothing" affairs.(n148) Either the defendant would be subject to the full range of damages, or would escape liability altogether. American courts were reluctant even to consider that liability for a single harm might be apportionable. They may have perceived that apportioning causation would be difficult, if not impossible,(n149) and any other basis for apportionment would lack scientific rigor.(n150) The fear that arbitrariness, emotion, and speculation might determine awards was too great for judges and legislators to take the notion of apportionment of damages seriously.(n151)

As all law students learn, the ultimate decision to plunge into damage apportionment arose out of an even greater dissatisfaction with one of the principal all-or-nothing schemes to limit liability, the defense of contributory negligence.(n152) Ameliorating doctrines such as last-clear-chance coupled with juries' frequent refusal to find negligence on the part of plaintiffs proved to be no panacea for the defense's harshness.(n153) As a result, comparative negligence in the context of jury trials(n154) was introduced and proved highly successful in the sense that the apportioning of damages has met with wide acceptance.(n155)

Comparative negligence rules in the cases involving a single plaintiff and a single defendant posed few additional difficulties for courts and legislatures. The most significant new issue was whether a plaintiff more at fault than the defendant in causing the plaintiff's injuries should recover anything at all.(n156) But in those cases involving multiple defendants, great complexity was added that had to be parsed by new rules.(n157)

Fortunately, in considering apportionment in the accounting context a good deal of commentary is available that focuses on general questions of contribution, indemnity, and joint and several liability issues.(n158) Unfortunately, there is little agreement on how these principles should be applied.

In the auditing context, a typical scenario involves a creditor of an enterprise who is unable to enforce the debt obligations due him because of the debtor's insolvency. When a demand for payment or a lawsuit by the creditor sounding in contract fails to produce a collectible judgment, the plaintiff institutes a separate tort suit for negligent misrepresentation against the enterprise's auditor.(n159) Other potential joint defendants such as officers, directors, attorneys, appraisers, and brokers may be sued as well. If such an action is permissible under the kind of rule established in H. Rosenblum v. Adler,(n160) the question arises whether the auditor can join its client, its client's tortious or criminal directors, officers, and other employees, and other culpable parties as third party defendants.(n161) The substantive ground for joining these parties would be that there is a single indivisible injury to the third party (its pecuniary loss) and that injury was proximately caused by erroneous financial information represented to the third party by both the auditor and the culpable defendants. The purpose of joinder would be to receive a judgment that would apportion damages to the third party from among all the culpable defendants, presumably one that would assess the auditor's fault at something less than 100 percent of the plaintiff's loss.

If the auditor succeeds in bringing in all potentially culpable defendants, there remains one major question: if the client and perhaps other culpable defendants are insolvent -- as will often be the case --must the auditor pay all or a portion of the judgment rendered against the insolvent parties? If the auditor is to be held jointly and severally liable for all the harm to the third party, the joinder exercise will be futile, and -- if the plaintiff is non-negligent --comparative fault principles will be of no use as a liability limiting device.(n162)

Because successful third party common law negligence suits against auditors are quite recent developments, we could find no decided appellate cases in which there had been apportionment of damages among multiple tortfeasors including an auditor.(n163) In addition, for reasons that will soon become apparent, there are only a few cases in which contributory negligence or comparative fault have been successfully raised as a defense by accountants.(n164) Of necessity, therefore, the discussion of the issues in the following subsections will not only be predominantly theoretical, it will have to rely on holdings derived primarily from personal injury and property damage precedents.

Contributory negligence

Contributory negligence as a defense to accountants' tort liability appears for the first time as an issue in Craig v. Anyon.(n165) In Craig, suits for breach of contract and negligence were brought by a securities broker against the broker's accounting firm. The client alleged negligence on the part of the firm in failing to discover the defalcations of a trusted employee. The accountants raised as an affirmative defense the negligence of the client and the negligence and criminality of its employees. In particular, the accountants asserted that the client should have discovered the loss and its cause without having to rely exclusively on the defendants. In reversing a jury verdict for the plaintiffs, a divided New York Court of Appeals held for the accountants on the issue of the client's contributory negligence.(n166)

The decision was widely attacked.(n167) Critics noted that the alleged negligence occurred in the performance of a contract entered into by the client expressly to free itself from having the responsibility to sniff out fraud.(n168) Why should the client be completely barred when the independent auditor has performed negligently? So argued the Craig dissent,(n169) whose view ultimately prevailed in New York(n170) and was adopted elsewhere.(n171)

Commentators felt there were sound policy reasons for limiting the scope of the contributory negligence defense by accountants. The value of accountants to the economy depends on their clients being able to rely on them.(n172) Of course, their undertakings are limited by contract, but within what they promise to do they should not escape liability altogether if they fail to perform at or above a reasonable standard. This view was later reflected in the National Surety decision(n173) in which the contributory negligence defense was limited to instances in which the client's negligence prevented the accountant from performing the contract and reporting the truth.(n174) Under a strict reading of National Surety, the client's negligent operation of the business will not excuse the negligent auditor, nor will the client's failure to follow the accountant's suggestions provide a defense.(n175)

In an all-or-nothing world the National Surety rule has weight. The negligent auditor who could have avoided the loss to its client by fully performing its contract of engagement should not be entirely insulated from liability simply because its client was lax. Yet, the unwillingness to provide negligent accountants with a complete defense can be applied with equal force to the proposition that a client who negligently fails to protect himself should not be able to obtain full redress from another party who merely compounds the wrongdoing by insufficient diligence.(n176) The accounting profession today would assert that the usual contract of engagement does not contain a warranty that fraud will be detected, nor is there a contractual obligation on the part of an auditor to actively search for all fraud regardless of materiality.(n177) Thus, it follows that the client who hires an outside auditor cannot relieve itself of its own obligations to maintain adequate internal controls and provide materially correct financial information.

Given the close balance of the equities in a time of complete defenses, it is unsurprising to find a split of authority on the issue of where the risk of loss should fall -- on the negligent client or the negligent auditor. In Shapiro v. Glekel,(n178) the court was apparently persuaded by the need for reinforcing public faith in financial information by choosing to apply the National Surety rule as controlling New York state law.(n179)

The case cited most often as following the Craig rule is Delmar Vineyard v. Timmons(n180) which held, quoting Craig, that a client cannot "'recover for losses which they could have avoided by the exercise of reasonable care.'"(n181) One commentator observes that Delmar Vineyard should have been decided for the accountants on the ground that their negligence was not a proximate cause (actually, not a cause-in-fact) of the client's loss; the loss would have occurred even if the accountants had fully performed.(n182) Nevertheless, based on its citation to Craig, had the accountant's sloppiness been material to the loss, the Delmar Vineyard court apparently would have absolved the accountants from liability by recognizing the client's own contributory negligence.

Section 552A of the Restatement (Second) of Torts recognizes the defense of contributory negligence in instances where the client unreasonably relies on the financial reports.(n183) For example, if the client knows that the auditor uses sampling techniques that may fail to detect a certain kind of fraud, yet, relying entirely on the audit, the client takes action assuming absolutely that this type of fraud has not occurred, the client could be held contributorily negligent; in such an instance the client's total reliance on the audit opinion would be unreasonable. One writer states that the Restatement's explicit recognition of unreasonable reliance as a ground for contributory negligence precludes other grounds such as the client's negligently "managing his business in a way that enables employee fraud to occur."(n184) That implied exclusivity is not at all clear, however.(n185)

We would argue that policy considerations favoring the compelling importance of accurate financial reporting have come to outweigh policies protecting the viability of the accounting profession. These policy considerations mandating better information for the benefit of investors, creditors, and taxpayers (where government is a guarantor)(n186) would dictate, however, that management not be allowed to shift its losses resulting proximately from its own laxness entirely to providers of attestation services.(n187) Presumably all the major actors in producing financial information should feel appropriate pressures to acquire and disseminate accurate data. The demand for better financial information requires a deterrent that punishes insufficient vigilance on the part of any and all parties capable of preventing pecuniary harm to third parties resulting from erroneous financial statements. Thus, when harm does occur, damages should be apportioned so that suitable precautions will be taken in the future by all those providing information important to the public.

Comparative Fault When There are Multiple Defendants

In Lincoln Grain, Inc. v. Coopers & Lybrand,(n188) the court reviewed the earlier cases dealing with the contributory negligence defense and opted to follow the National Surety and Shapiro precedents (which greatly limited the defense for auditors), rather than the unlimited rule of

Craig v. Anyon,(n189) despite the fact that Nebraska had adopted comparative fault, making it likely that at least some liability would be imposed on the negligent auditors.

In Devco Premium Finance Company v. North River Insurance Company,(n190) a Florida appeals court rejected the conclusion reached in Lincoln Grain, pointing out that the National Surety case, upon which the Lincoln Grain court had relied, had been "decided on the principles of contributory negligence, a doctrine which has been repudiated in [Florida]."(n191) The court affirmed a judgment apportioning twenty percent of the fault to the auditor for negligently conducting its audit and eighty percent to the client for negligently failing to follow up promptly the creditworthiness of its customers.(n192)

Both of these cases involve a single defendant -- an accountant sued by its client -- but they illustrate the threshold issue that must be overcome before comparative fault can be employed as a limiting principle in suits brought by third parties. The auditor must be permitted to assert the fault of others as a partial defense. The Lincoln Grain rule would appear to preclude such a defense, except when the auditor is prevented by the client, or a third party, from performing its contract and reporting the truth.

If the rule in Devco Premium (and not Lincoln Grain) were to apply, an auditor could assert by way of defense the negligence of its co-defendants, third party defendants, and third party plaintiffs. But it can be argued that finding a formula for apportioning damages among the culpable parties is a particularly difficult matter in auditing cases. Apportionment in personal injury cases can reasonably be sought from juries composed of ordinary persons because most of us are familiar with the instrumentalities that cause these injuries and many of the circumstances under which they are used. Common sense evaluations of relative culpability in these cases are possible. In auditing cases, however, neither juries, nor judges acting as fact finders, are likely to be familiar with the technical principles and standards applied by the auditors, the inherent limitations in applying them, or the alternatives that might have been applied -- and their limitations.

This unfamiliarity of fact finders with the technical background of the cases they have to decide is a common problem in complex litigation. It is a problem beyond the scope of this article, but the authors are reasonably confident that seasoned advocates should in time be able to reduce the issues in the auditors' cases to the point where juries or judges will be able to make apportionment decisions on some reasonable basis.

We assume that in applying comparative fault principles, the trier of fact will seek to apportion damages on the basis of culpability rather than causation. Once multiple causes have joined to produce an indivisible injury, it is not simple to develop a principled method for assigning causal portions to all antecedent actors. The desirability of attempting to do just that was given impetus in the late seventies and early eighties in order to apportion damages in strict liability cases in which fault was to play no part.(n193) In the auditor cases, however, it is generally agreed that the rules of negligence and intentional torts (deceit) apply, and so we need not comment on whether and how causation can be apportioned except to note that the magnitude of each actor's contribution to the injury is a factor the trier of fact should be asked to weigh along with the quality of the actors' conduct. That quality assessment would include the foreseeability and measurability of the harm ex ante, the variance of the parties' conduct with the reasonable standard of care, and, we would add, the potential gain to each party from the enterprise.(n194)

A comparative fault regime would appear to meet tort law's fairness and deterrence objectives more effectively than one in which contributory negligence is a complete defense. Fairness is achieved because the plaintiff receives full compensation from the culpable tortfeasors less what the plaintiff is deemed to have contributed to her own injury, and each defendant is assessed in proportion to his culpability. At the same time, appropriate levels of deterrence are achieved by proportionate assessment, because to assess defendants a greater share of damages than what they contributed to the plaintiff's injury would over-deter them, while correspondingly under-deterring the other responsible parties.

So long as all responsible parties are joined in the action, the potential for meeting fairness and deterrence objectives is present.(n195) But even if all parties are before the court, a problem arises if a culpable defendant is insolvent or immune from suit. In such a case the plaintiff must either be awarded less than full compensation or culpable defendants must be assessed more damages than the fact finder has determined to be their equitable shares. Under the common law doctrine of joint and several liability, the resolution in favor of full compensation is clear. Whether such a rule is fair and economically efficient in the auditors' cases will be taken up in the following sections.

The Effect and Fairness of Joint and Several Liability in the Auditing Context

When there is a single defendant who is immune from suit or insolvent, the goal of compensation for the victim is frustrated. This result is particularly regrettable when the plaintiff is entirely free of fault, because the entire loss falls on that unlucky, innocent victim.

When there is more than one defendant the possibility exists for shifting the risk of loss from the innocent victim to solvent joint or concurrent tortfeasors. By applying the common law rule of joint and several liability, the plaintiff can recover from any and all defendants found liable for proximately causing the harm. Whether this result is fair is an issue that will be discussed below. Whether it is economically efficient will be considered in the next subsection.

Accountants have focused on the joint and several rule as particularly burdensome because of the high probability that, in cases brought by creditors, guarantors, and investors against defalcating enterprises, the accountants are likely to be the only deep-pocket defendants available to meet the judgment.(n196) In the general case, an insolvent primary defendant is a relatively unusual phenomenon; in the financial failure eases, it is the norm. In the past, the joint and several rule was not an important concern to accountants because, under Ultramares(n197) and the Restatement,(n198) the auditor was completely shielded from liability to unforeseen third parties. In jurisdictions following the foreseeable third party rule of H. Rosenblum v. Adler,(n199) however, the exposure to liability could be virtually unlimited. If accountants' liability to foreseeable third parties is to become the general rule in the United States, surely some middle ground can be found for apportioning losses among the parties.

There is a substantial constituency spearheaded by manufacturers, liability insurance interests, municipalities, and professionals like CPAs that seeks to abrogate or at least modify the joint and several regime.(n200) Advocates for this position argue that the emergence of comparative fault principles makes joint and several liability obsolete and unnecessary.(n201) This "tort reform" group has met with some success in both the courtroom and in state legislatures.(n202)

Opponents of changing the joint and several rule point to another change in the common law that has softened the harshness of the joint and several rule on defendants. Under common law, actions for contribution among joint tortfeasors were not permitted.(n203) Today, however, such actions are allowed under the majority rule.(n204) Therefore, it is argued, the fairest scheme is for culpable defendants to be assigned the burden of seeking relief from the other defendants, rather than forcing an innocent victim to bear the costs of chasing down each and every malefactor in order to collect each one's share of the harm.(n205) To this, the accounting profession responds that a right of contribution or indemnity is a hollow remedy indeed when one's co-defendants are likely to be judgment-proof.(n206)

A second, more traditional argument against the proposal for abrogating joint liability is that in choosing which party on whom to assign the cost of injury that is initially uncollectible, it is better to punish a proven wrongdoer than an innocent victim.(n207) To this, defendants reply that extreme facts expose the fallacy in this moral argument. Can it possibly be just, they ask, to assign a slightly negligent tortfeasor -- say, one percent culpable under a comparative fault determination --to bear 100 percent of the plaintiff's damages when the principal culprit is immune or insolvent?(n208) This is, after all, a risky world for the innocent as well as the culpable. As one court put it, "Between one plaintiff and one defendant, the plaintiff bears the risk of the defendant being insolvent; on what basis does the risk shift if there are two defendants, and one is insolvent?"(n209)

In John Wade's lucid exposition of eight historical steps in the development of the joint and several doctrine,(n210) he notes that each succeeding "step evolved in an effort to be more fair in the treatment of the parties."(n211) He points out that originally, joinder of multiple tortfeasors was possible only when they acted in concert.(n212) If the torts were concurrent, but not concerted, the plaintiff had to maintain separate actions, but could recover his entire damages from whichever defendant he chose to sue. To make things easier for plaintiffs, joinder later was allowed, permitting the plaintiff to receive judgment for the full amount of her damages from each d e fend ant.(n213)

The next development permitted the joining of multiple tortfeasors in a single action, with apportionment of damages when separate (measurable) injuries were incurred.(n214) This was followed by the enactment of statutes permitting pro rata contribution actions by defendants when a single indivisible injury was experienced by the plaintiff, even in cases where joint judgments had not been rendered against the defendants.(n215) Still later, third party practice procedures made it possible for "deep pocket" defendants, if sued alone, to bring in other defendants to "obtain a determination of the appropriate share of liability to be placed on each of them, and obtain contribution."(n216)

The final three stages identified by Wade follow the emergence of comparative negligence. He points out that the "principles of comparative negligence and contribution among joint tortfeasors have a mutual affinity."(n217) Comparative negligence, he notes, violates two sacredly held common law policies: "(1) a wrongdoer is not entitled to seek relief from the court, and (2) the choice must be confined to recovery of either all or nothing."(n218) Experience has shown that neither policy was an indispensable element of American tort jurisprudence.

The penultimate stage of development, Wade calls comparative contribution, or equitable indemnity.(n219) Under this principle, damages for indivisible injuries are in fact divided according to culpability percentage determinations (rather than pro rata) among all parties to the action. The final stage of development, identified with the modern tort reform movement, seeks a "several or separate" liability rules.(n220)

Dean Wade balks at the consequences of a pure proportionate several liability rule. That the entire burden of an insolvent defendant should fall on an innocent, or even negligent injured party he finds "not even debatable."(n221) His suggestion is to divide the insolvent tortfeasor's share among all responsible parties in proportion to their fault.(n222) Of course, in a case where an auditor is sued by a fault-free creditor and is found twenty percent at fault, and the insolvent client is found eighty percent at fault, Wade's "fairer" scheme would assess the auditor for 100% of the creditor's damages.

In considering the fairness of applying the joint and several rule to accountants, there are two distinguishing aspects of these cases that seem relevant. First, it is arguable that the scope of liability should somehow be tied to the defendant's stake in the enterprise. A product manufacturer held jointly and severally liable has had the opportunity to glean unlimited profit from the enterprise. An accountant's compensation, however, is limited to a fee for time spent by the accountant on the audit engagement. To hold equivalent the upper limit of both parties' liability exposure (which is the result of a joint and several rule) seems disproportionate. The equity of this argument gains support from those new comparative fault statutes that apply joint and several liability only when the fact finder finds a statutory minimum percentage of fault on the part of a defendant who is neither immune nor insolvent.(n223) Presumably, juries would find the auditor's percentage of fault low in relation to that of an insolvent negligent or fraudulent client so that in those jurisdictions, either a de facto several rule or reduced joint liability would be expected to apply to the auditor's negligence.

A second characteristic of these cases is their purely pecuniary nature. The urgency of the policies protecting victims of personal injury and property damage is less intense when only financial loss is involved. The persistence of a privity rule in accountant cases after its abrogation many years ago in personal injury cases supports this proposition.(n224) Moreover, the typical third party victims of negligent misrepresentation are generally on notice that their loans, deposits, or investments are subject to numerous risks including those flowing from a world of imperfect information. While they should not be remediless if they rely to their detriment on misleading financial information, it is hard to argue that their remedies should extend beyond the culpability of solvent tortieasors. The creditor, guarantor, or investor has available several ways to protect himself ex ante against the later possibility of an insolvent tortfeasor. Besides the mechanisms of independent audit and possibly insurance,(n225) the plaintiff in these cases is generally able to adjust the price he demands for participating in the enterprise: the creditor can demand a higher interest rate; the guarantor a higher fee; and the investor a lower share price or higher dividend. Surely the reasonably foreseeable class of plaintiffs in these cases are less in need of a joint and several rule than the victims of unreasonably dangerous product defects.

Dean Wade and Professor Richard Wright argue strenuously against abrogating the joint and several rule. Ultimately both writers return for support to the concept that the tortfeasor should be responsible for all the consequences of his act when it is the proximate cause of an indivisible injury.(n226) This notion identifies tort liability with causation. Comparative fault principles, however, predicate liability on measuring relative culpability. Culpability or fault or responsibility, unlike causation, can readily be apportioned and allocated.(n227) The process requires an intuitive weighing and balancing of factors,(n228) but by and large it is a process that has met with acceptance. Causation is an essential element of every tort claim, but under comparative fault, once proximate cause is established, causal weight becomes but one factor in the apportionment of damages. To say that "'every fair-minded person agrees: a person should pay for damages he has caused, but not for damages he has not caused,'"(n229) confuses the issue. The better rule would be that a person should pay for damages for which he is found culpable, but no more than that.(n230)

One writer has pointed out that retention of joint and several liability in a comparative fault jurisdiction unfairly favors plaintiffs over defendants.(n231) Dean Wade's response to this was that "[t]he doctrine of several liability on the basis of fault does exactly the same thing, except that it favors the defendants over the plaintiff; since it always imposes the responsibility of an uncollectible allocation on the plaintiff, regardless of whether or not he is at fault."(n232) Wade's observation suggests that focusing on questions of fairness may be misplaced. Powerful fairness arguments can be mounted both in favor or against retention of joint and several rules. If the equities appear fairly balanced, as here, perhaps we should focus on whether a several liability rule change that benefits defendants will maximize social utility or wealth more than retaining the joint and several rule that benefits plaintiffs. First, however, there are two doctrinal problems involving comparative fault that have to be resolved.

Two Doctrinal Problems

Apportionment of damages among multiple tortfeasors for indivisible injuries generally requires the existence of a comparative fault system embodying comparative contribution. Without such a system, there is generally no legal basis for such apportionment, and joint and several liability will be applied. Although actions for contribution or indemnity may be permitted, these will be of no benefit to solvent tortfeasors if brought against insolvent co-defendants. Thus, for a several only rule to be effective, the trier of fact must be permitted to assess each party's percentage of fault in order to set the limit of that party's liability.

But even with the adoption or enactment of comparative fault, there may be certain types of conduct that are not within the scope of the jurisdiction's system. For example, in some jurisdictions strict liability cases are excluded from comparison. In the negligence realm, in which we find the auditor cases, there are two interrelated doctrines which if not modified, would restrict the application of comparative fault principles.

The first of these is the rule followed by most courts that intentional tortious conduct may not be compared with negligence. When, as is often the case, there are allegedly fraudulent misrepresentations by some of the defendants in a tort suit brought by creditors, investors, and guarantors to recover their losses, the issue will arise whether their conduct is subject to comparison with that of the enterprise's auditor who has been-joined as a defendant under the theory of negligence. The second doctrine, which appears to be a minority rule, is that negligent misrepresentation should not be subject to comparative fault treatment. The reasoning justifying both rules has some validity; fortunately, accommodating the underlying rationales need not be fatal to the apportionment principle.

Should Intentional Conduct Be Compared With Negligence?

The weight of authority holds that the acts of intentional tortfeasors should not be compared with those of plaintiffs and joint defendants who are found to be merely negligent.(n233) A few courts have permitted such apportionment in specific circumstances, and commentators have recommended the adoption of such a rule,(n234) but only recently has a state supreme court held that its state's comparative negligence act would permit such comparison as a general proposition.(n235)

Under the no comparison rule, if a negligent auditor's joint tortfeasors have acted fraudulently, apportionment would be forbidden under comparative fault law. The rationale for the rule is clear enough: because contributory negligence at common law was not recognized as a defense to intentional torts,(n236) comparative negligence should not be permitted as a partial defense.(n237) To the argument that even victims should be responsible for consequences flowing from their own folly, the public policy reply is that "no rogue should enjoy his ill-gotten plunder for the simple reason that his victim is by chance a fool."(n238) The policy served by this rule is reasonable, but given the evolution of comparative fault described in the previous section, an unmodified "no comparison" rule would defeat the use of comparative fault as a device for achieving comparative contribution or equitable indemnity.(n239)

The problem is well illustrated by a Kansas case in which a vendor of a house and his broker fraudulently conspired to conceal evidence of termite damage from the vendee.(n240) They suppressed the first termite inspector's report and hired a second inspector who negligently failed to discover the damage. The trial court found all three tortfeasors jointly and severally liable to the vendee for damages. One of the fraudulent defendants argued that damages should be apportioned under comparative fault principles and a portion assigned to the negligent inspector, thus reducing the damages remaining for the intentional tortfeasors.(n241) The Kansas Supreme Court could find no basis for such an apportionment and refused to order the trial court to compare culpability.(n242) The practical result of this holding was not too unreasonable inasmuch as the plaintiff was presumably able and willing to recover his entire loss (plus punitive damages) from the intentional tortfeasors. But what if the vendor and broker were insolvent, would it serve justice for the termite inspection company to absorb the entire judgment? We think not.

The no comparison rule should be modified. Although it is arguable that comparative fault should not provide a defense for an intentional tortfeasor against a negligent plaintiff, it can still provide a basis for assigning a percentage of culpability to negligent defendants. There is no inherent reason why the trier of fact cannot assign a fault percentage to a negligent actor, even when a defendant who has acted intentionally is also at fault. To argue that intentional conduct and negligence differ in kind and not in degree-- and therefore cannot be compared(n243)--is too glib.

In Blazovic v. Andrich, a unanimous New Jersey Supreme Court rejected "the concept that intentional conduct is 'different in kind' from both negligence and wanton and willful conduct, and consequently cannot be compared with them."(n244) Rather, it viewed "intentional wrongdoing as 'different in degree' from either negligence or wanton and willful conduct."(n245) The court in earlier cases had paved the way for this holding by ruling first, that ordinary negligence and gross negligence, including willful and wanton conduct, differed only in degree and thus could be compared,(n246) and second, that New Jersey's Comparative Negligence Act "'was intended to cover fault in a broader sense rather than in the narrow negligence concept,"(n247) thus permitting the state's courts to compare species of fault such as wrongful conduct covered by rules of strict liability. Given this foundation it was not a great leap for the court to subsume intentional conduct within the Act.

In Blazovic, a lower court dissenting judge had expressed concern that apportionment in such cases might cause plaintiffs to be "disadvantaged if fault were substantially allocated to intentional wrongdoers who were not financially able to satisfy the judgment."(n248) The supreme court observed that for the instant case the plaintiffs were protected by the common law rule of joint and several liability, but a subsequent amendment to the Comparative Negligence Act now abrogates that rule for defendants found less than sixty percent at fault (twenty percent for economic damages).(n249) Despite the possibility that plaintiffs might now receive less than full compensation when some intentional defendants prove to be insolvent the court declined to modify its holding.

The court acknowledged there were still viable New Jersey precedents by which courts could refuse to reduce a negligent tortfeasor's judgment under comparative fault principles. In these cases the negligent party has a heightened duty of care to "prevent the plaintiff's allegedly inappropriate conduct" that leads to injury.(n250) In Blazovic, the court held that the tavern owner's failure to maintain a well lighted and secure parking lot, so that its customer would have been less likely to have provoked the defendant's battery, did not fall under the heightened duty exception. The court adhered "to the general principle that liability be imposed in proportion to fault,"(n251) presumably, even if the intentional tortfeasor's share of the plaintiff's judgment proves uncollectible. Inasmuch as the New Jersey Supreme Court has opined in H. Rosenblum v. Adler that the Comparative Negligence Act would be available in third party suits against auditors,(n252) it is fair to predict that an auditor found twenty percent or less at fault in that state would not be required also to meet the judgments rendered against insolvent, fraudulent co-defendants.

Arguably, public policy may demand that the intentional actor be required to indemnify negligent defendants (if he has the resources to do so), but all tortfeasors should initially share responsibility for the victim's damages in proportion to percentages determined by the trier of fact. It should be no more difficult to assign such percentages than when all defendants have acted without scienter; the basis for allocating responsibility, is always a matter of judgment and moral weighing.(n253) To the argument that such a procedure is speculative, the reply is that the rapid adoption of comparative fault in this country suggests that there exists a national consensus holding that even speculative apportionment is preferable to the all or nothing regime of the common law.(n254) To the argument that the fraudulent rogue should always be assigned all of the victim's damages, the reply is that to do so means holding the negligent actor blameless for the harm he has permitted to occur. As the Blazovic court observed, if culpability allocations stick in the craw under these conditions, the law of punitive damages can be used to reestablish appropriate levels of punishment and deterrence.(n255)

In Fleming v. Threshermen's Mutual Insurance Co.,(n256) the Wisconsin Supreme Court would not permit the comparing of the battery of an intentional tortfeasor with the negligent acts of the plaintiff and another defendant, but the court approved a right to indemnity for the negligent tortfeasor in order to readjust the ultimate awards. The court held:

[A] negligent tortfeasor has a right to indemnity from an intentional joint tortfeasor.... While this approach allows a defendant who is causally negligent to escape from liability in some circumstances, we believe that shifting the full responsibility for the loss to the intentional tortfeasor serves the policy of deterring conduct which society considers to be substantially more egregious than negligence.(n257)

The Fleming court denied a right to contribution, however, observing that, "[w]ere we to allow a negligent tortfeasor only a right to contribution from an intentional joint tortfeasor, the intentional tortteasor effectively would receive the benefit of contribution from the negligent tortfeasor, in direct conflict with the law in this state.(n258)

We agree with the Blazovic court that the better rule is to permit contribution, to be achieved by the application of comparative fault principles that would include comparing the acts of all tortfeasors. Culpable negligent tortfeasors as well as intentional ones should be assessed their share of responsibility for harm done. To shift liability for compensatory damages completely to the intentional tortfeasor will underdeter for negligence. If egregious conduct is to receive special attention, the use of punitive damages would appear to be the appropriate vehicle.

Should Negligent Misrepresentation be Subject to Comparative Fault Rules?

There are authorities that hold that comparative fault is inapplicable to cases involving pecuniary injury alone. The case generally cited for this proposition is Carroll v. Gava(n259) in which a California court held "that the concept [of comparative fault] has no place in the context of ordinary business transactions."(n260) The court reasoned that the application of comparative fault principles was "designed to mitigate the often catastrophic consequences of personal injury," and "would only create unnecessary confusion and complexity in such [pecuniary] transactions."(n261) The plaintiffs had alleged that the defendant vendors had misrepresented to them the zoning status of a piece of property. The trial judge was unable to find the necessary scienter to establish intentional misrepresentation on the part of the defendants, but he refused to compare the parties' relative responsibility in holding the defendants liable for negligent misrepresentation. In affirming, the appellate court found the defendants' statements to be false and virtually, if not legally, fraudulent.(n262) The court's holding appears to reflect a conviction that it was dealing with the equivalent of an intentional tort for which neither contributory nor comparative negligence should be a defense.

In a later case, Garcia v. Superior Court,(n263) the dissent pointed out that, under California law, a misrepresentation made because of the defendants' failure to exercise due care, and which results in physical injury, is not to be treated as negligent misrepresentation, but rather as ordinary negligence.(n264) Presumably, in such an instance, comparative fault would be applicable. In Dhanda v. Tri M. Ltd.,(n265) a Massachusetts court pointed out that its state statute limited the application of comparative fault to "negligence resulting in death or injury to person or property."(n266) The court noted that comments to the Restatement considered it "debatable" whether comparative negligence should include pecuniary harm.(n267) But this court also noted that the authorities were divided on the issue.(n268)

In Florenzano v. Olsen,(n269) the Minnesota Supreme Court reversed a lower appeals court, which had relied on the reasoning of Carroll v. Gava. The supreme court observed that the "majority of other states considering the case disagree and have held principles of comparative responsibility applicable to cases of negligent misrepresentation."(n270) The court further noted that commentators agree with the majority rule, and "Professor Prosser states that there is 'no apparent reason for distinguishing negligent misrepresentation from any other negligence in [the application of contributory or comparative negligence concepts].'"(n271) The Carroll v. Gava holding reflects an understandable reluctance to expand the application of comparative fault concepts, except with great caution--especially when subtle distinctions must be drawn between intentional and negligent conduct. But clearly the majority rule favoring comparative fault application as articulated by the Minnesota Supreme Court is the better one: apportionment of responsibility is a principle that has been tested for the better part of a century and has met with wide approval. We would urge that the concept be applied with greater boldness, especially in the apportionment of culpability among joint tortfeasors, whether their acts are intentional, negligent, or something in between.

The Efficiency of the Joint and Several Rule

Landes and Posner(n272) define an efficient negligence rule as one that maximizes wealth(n273) by minimizing the sum of the expected cost of accidents and the cost of precautions exerted to prevent accidents.(n274) In the case of auditors and their clients' negligent misrepresentations, we can consider the "accident" to be the event of pecuniary loss proximately caused by the misrepresentations to creditors, investors, and guarantors, and its cost to be the dollar amount of the loss that is suffered.(n275) The cost of precautions is the quality control expenditure made by both auditors and their clients to avoid negligently caused loss. If either the client or the auditor could have prevented the accident by taking due care, and they both fail to do so, the case becomes what Landes and Posner call a simultaneous joint tort of the alternative care variety.(n276) In such an instance the optimum rule would be to assign liability only to the lesser-cost avoider.(n277) Presumably, this party would be the auditor's client, because the client can more easily evaluate its own assets and liabilities. Thus, a common law privily rule would accomplish the optimum result; third parties would be barred from suing the auditor for negligence, and only the lesser-cost avoider, the client, would be liable.

Landes and Posner are wary of this formula because the lesser cost avoider could be judgment-proof and, therefore, have no incentive to exercise due care, or any care for that matter.(n278) In such a case, the second actor who could avoid the harm is assigned "backup liability in order to achieve a second-best solution in circumstances in which the best solution is not feasible."(n279) Such a result is less than optimal, but is "preferable to zero care for both A and B--the outcome that would result if A were judgment-proof and B were not jointly liable."(n280) This general proposition would appear to support the rule of reasonable foreseeability found in H. Rosenblum v. Adler which holds that the auditor should be assigned back-up tort liability to foreseeable third parties in the event the insolvent client cannot meet its contractual obligations to those parties nor meet any tort judgments rendered against it in favor of those parties.(n281)

Landes and Posner proceed to demonstrate that having joined the higher cost avoider as a joint tortfeasor, the common law rule prohibiting contribution (but permitting indemnity) among joint tortfeasors in alternative care cases is more efficient than a rule permitting contribution.(n282) This is so, they say, because contribution suits are expensive to administer.(n283) To the argument that such a rule will underdeter fraudulent and negligent behavior, they argue that contribution is unnecessary as a deterrent because if "ex ante, each defendant bears a cost (an expected cost) of liability, each defendant will be deterred, even if ex post all but one pay nothing."(n284) Landes and Posner also assume that an efficient rule requires that non-negligent victims can expect ex ante to be fully compensated by their negligent injurers.(n285)

The theoretical model developed by Landes and Posner assumes that the parties have "no contractual relationships with each other" and that "the costs of voluntarily negotiating levels of care or accident avoidance is prohibitive."(n286) In the auditor cases neither of these conditions are present. Between auditors and clients there are contracts of engagement and between clients and various third parties there are contracts of debt and investment. As a result, it is not prohibitive for care levels to be negotiated ex ante between auditors and clients, although the cost of such negotiations would generally be prohibitive between auditors and third parties. On the other hand, the risk of client insolvency coupled with auditor negligence can be negotiated ex ante between clients and third parties. That some risks of negligence can be allocated ex ante by contract in these relationships provides an opportunity for using both tort and contract law to optimize efficiency imperatives.

At first glance it might appear that, under a joint and several regime, auditors may be well positioned to bear initially the risk of client insolvency and then to spread it efficiently.(n287) If auditors can accurately estimate the additional exposure to loss they will suffer because of a joint and several rule, they can determine the necessary level of precaution expense they must incur and can then seek to pass through this additional cost of doing business by raising their audit fees by commensurate amounts. As a result of this roundabout process, clients would be bearing the risk to third parties of their own insolvency in those cases when their auditors could also be held liable for negligent misrepresentation.

There are three major problems with this scenario, however. First, it is difficult for auditors to assess the risk dimensions facing them. Second, there is no assurance that the extra precautionary expenses can be passed through to clients through greater audit fees. And third, the insistence of full ex post compensation to third party victims will increase litigation costs. These problems will be discussed in the following subsections after which the authors will consider the structural changes that might occur in the accounting profession if common law privily barriers are eliminated but the joint and several rule is retained. This part concludes by considering whether the elimination of privily accompanied by a proportionate several only rule would be economically more efficient.

Estimating Auditors' Risk

Audit Risk and Negligence Principles

Auditors are confronted with two interrelated risks. Audit risk is the probability of auditors issuing incorrect audit opinions because of their failure to detect material errors and irregularities in their client's financial statements.(n288) We define liability risk as the probability of an auditor issuing an incorrect audit opinion and being found liable for negligence.(n289)

Negligence rules require that there be potential liability whenever the auditor has failed to take precautions commensurate with the quantum of harm that could occur to parties to whom the auditor owes a duty of care.(n290) This quantum of harm is estimated ex ante by calculating the probability of an incorrect audit opinion being issued multiplied by the probable magnitude of pecuniary loss that will be suffered by the plaintiff class. Auditors are then expected to expend resources on precautions equal to the estimated quantum of harm. Thus, liability risk is a function of probability, magnitude, and precautions. The liability risk increases with increases in probability and magnitude and decreases with precautions.

For the tasks of calculating and minimizing audit risk, auditors use Generally Accepted Auditing Standards (GAAS)(n291) The operative parameter of GAAS is that of materiality.(n292) Auditors consider themselves responsible for detecting only material misstatements.(n293) Materiality is a relative term referring to the magnitude of the misstatement compared with the total financial activity of the enterprise under audit.(n294) Thus, an undetected million dollar embezzlement could conceivably be deemed immaterial in an audit of a multi-billion dollar enterprise.

Auditors sued for malpractice or negligent misrepresentation will often argue that liability risk should depend solely on whether GAAS has been followed, but it is clear that negligence liability can be imposed despite an auditor's adherence to GAAS.(n295) For example, if the auditor following GAAS were to underestimate the quantum of harm threatened by a misstatement and, as a result, she failed to take commensurate precautions, she may have breached her duty of care, even though the misstatement was arguably immaterial. Conversely, losses can occur in the absence of negligence in instances when, for example, the cost of preventing (detecting) the misstatement would be greater than the total probable harm that the misstatement might proximately cause.(n296) Audit risk is related to liability risk in the sense that efforts to reduce the one will tend to reduce the other, but there is no assurance that meeting professional auditing standards will satisfy the law, or that merely avoiding negligence liability is sufficient to conduct a satisfactory audit.

Audit risk presumably should not change with changes in legal liability rules, but liability risk would certainly be subject to such change.(n297) In moving from an Ultramares privily rule to an Adler reasonable foreseeability one, a jurisdiction would dramatically increase liability risk for its auditors, although adherence to GAAS would provide that audit risk would remain as before. And if the rule of joint and several liability were retained at the same time privily barriers were relaxed, liability risk would be even greater.

These differences reflect the considerable tension existing between the accounting and legal professions, the two principal authorities charged with defining the scope of auditors' duties. For example, accountants and judges differ markedly in their attitudes over the auditor's duty to actively search out fraud. The American accounting profession accepts a general responsibility to detect material fraud but contends that certain types of fraud, particularly forgery and collusion, may not be detected even in a properly designed and executed audit. Lawyers and judges tend to believe that the duty to detect all material fraud exists and is paramount.(n298)

We take no position in this article as to which of the two authorities is correct except to state the obvious: the legal standard must prevail, whether right or wrong. Societal actors, even respected professions, cannot be permitted to circumscribe the standard of care they owe to others. Yet, when good faith tension over professional standards persists, perhaps the selection of legal rules governing damages in such cases should be responsive. In deciding whether to embrace or reject common law damages rules such as joint and several liability, we would argue that the current tension over professional standards is relevant; a damages-limiting approach seems more equitable for an activity for which there is little consensus as to standards, as opposed to an activity for which there exists relative unanimity as to the duties owed.

Not only can changes in legal rules increase liability risk, they can increase the uncertainty in calculating that risk. Under a strictly applied privily rule the auditor's liability risk assessment can be made with greater precision than under the reasonably foreseeable plaintiff rule. This is so because under the latter rule the class of potential plaintiffs is larger and their potential losses proximately caused by audit failure is more complex to estimate ex ante than would be the case if a duty of care were owed only the client. For example, there may be third party creditors, investors, and guarantors who risk their funds for reasons independent of an audit opinion. If this group could be readily identified ex ante, those risks could theoretically be removed from the auditor's liability risk assessment.(n299) Determining the class of foreseeable plaintiffs and estimating the magnitude of their potential losses is a daunting challenge to auditors operating under a reasonably foreseeable plaintiff rule.(n300)

Despite the difficulty of performing an ex ante liability risk calculus, society requires it of persons who would act reasonably. Under negligence principles auditors must make the best assessment they can, then take appropriate preventative action through the audit design and the quality control measures employed in carrying out the audit task.

To protect themselves against underassessment of liability risk, accounting firms generally purchase professional liability insurance (PLI). PLI, however, provides only a minimal investment in injury prevention through the insurer's ongoing monitoring of risk factors.(n301) PLI's principal purposes are to protect the auditor against financial catastrophe, to provide reassurance to potential victims that there will be a fund to compensate them for their injuries, and to establish a basis for shifting all or part of the risk of audit failures from the auditor to the client through increased fees sufficient to cover PLI premium amounts. These insurance roles are performed at a price, however. Insurance premiums include substantial administrative expenses and profits to insurers.(n302) These additional costs add little if anything to social wealth; rather, most of this "overhead" should be added to the aggregate cost of financial "accidents." Therefore, legal rules that would increase the role of insurance are less efficient than rules that encourage actors to bear risk with less insurance.(n303)

When the ex ante risk assessment is highly uncertain, the use of liability insurance can normally be expected to increase. Such is probably the case with auditors operating under the new relaxed privity rules.(n304) On the other hand, to insulate auditors from liability to foreseeable third party victims by a return to Ultramares would reduce the incentive for auditors to prevent harm to those parties. Because it would presumably require less PLI expenditure, the more efficient rule would hold auditors liable only for their share of responsibility for the total harm caused by undetected misstatements -- so long as third parties will be assured of either full ex post recovery from all the culpable parties or ex ante compensation for the risk that some culpable parties will later prove to be insolvent.

Full protection of third parties from the risk of tortious conduct can be obtained in two ways. First, auditors can be assigned initially, through the joint and several rule, the liability risk of their own negligence plus the risk of their clients' insolvency. They would then be free to negotiate higher audit fees that shift the latter risk back to the client. As we have seen, however, the auditor will have great difficulty in calculating this fee component because the risk of harm to relying third party users is a highly uncertain calculation.(n305) And even if the risk of harm were readily calculable, we shall see in a later section that passing it through fully in fee negotiations is problematic in today's auditing environment.(n306) The second, more efficient approach is to encourage third parties to negotiate ex ante the risk of insolvency with the auditors' clients through the use of the pricing mechanisms of ordinary financial markets.(n307)

Agency Effects, Macroeconomic Uncertainties, and Reduced Candor

Accounting firms face three additional difficulties in assessing the probability and extent of audit failure. The first is calculating the probability that individuals associated with the firm will act negligently. Economic analysis of legal rules generally assumes monolithic actors who respond rationally to the incentives of the rule under analysis. But accounting firms, like most organizations, are composed of individuals with personal agendas that are not always congruent with the interests of the firm. Despite stringent supervision and exemplary training, the acts and omissions of individual accountant employees, partners, and non-professional staff members can produce unexpected derelictions that run counter to the firm's interests. This "agency" problem adds yet another dimension of unpredictability and uncertainty to the firm's risk calculus.(n308)

A second problem flows from the unpredictable effects of events external to the audit task about which the auditor has little knowledge and over which he has no control. For example, the collapse of the petroleum-based economies of Texas and Louisiana was probably as great a factor in those states' savings and loan failures as were the fraud and mismanagement of individual S&L enterprises. In a better business climate, material misstatements of financial information probably would have led to less harm.(n309)

Finally, there is a client-accountant communication problem to be considered. As financial difficulties begin to close in, business clients become very closed-mouthed, even to their auditors, about their desperate, perhaps even fraudulent maneuvers to stave off disaster. This diminution of candor at times when it would be most useful for risk assessment further negates the use of auditors as deep pocket risk spreaders for insolvent enterprises.(n310)

Shifting Risk Among the Parties

A number of writers have observed that auditors find it difficult to shift much of the risk of malpractice and third party liability to their clients through higher fees.(n311) Auditing has become a mature industry requiring professional expertise but no extraordinary or rare talent. Practitioners are abundant, creating a buyers' market in which auditing has become a commodity. In the classic economic model, the marginal firms in such an industry would drop out(n312) and prices would then rise as the supply of auditing diminishes.

But the story is more complex for the auditing industry. Instead of going out of business many (but not all) accounting firms have successfully shifted their resources to providing increasingly varied tax and management advisory services (MAS).(n313) To market these generally more profitable tax and consulting services to clients, entree through an audit engagement is very useful. But to implement this strategy, auditing services have to be priced attractively. A firm that would pass through the full cost of its enhanced liability precautions and insurance premiums in its audit fees might very well find itself priced out of the auditing market. As a result, auditing services have become a highly competitive price leader for many accounting firms.(n314) Inasmuch as auditing services are frequently subsidizing MAS growth, it is not clear where the costs of more stringent liability rules are coming to rest. It is clear that the accounting profession believes it is absorbing the lion's share.(n315)

The sudden raising of the stakes of litigation by tearing down privity barriers while maintaining the joint and several rule is likely to be highly distorting. Under such a regime the real cost of audits will have to increase no matter which parties absorb the cost.(n316) Although increased exposure to tort liability will no doubt cause auditors to spend somewhat more on quality control,(n317) it is likely that the greater response will be for auditors to shift the risk of complete disaster by purchasing additional professional liability insurance (PLI). There are three reasons why the latter strategy is attractive to accounting firms: First, expenditures on auditing quality control are likely to run into diminishing returns fairly early on.(n318) Part of the reason, as noted earlier, is that accounting firms, like most organizations, must depend on individuals associated with the firm whose interests could differ from that of the firm's.(n319) Second, accounting firms are not limited liability organizations; the partners are personally responsible for judgments rendered against the firm.(n320) Third, individuals and businesses are usually risk averse at least before they are faced with specific losses;(n321) risk spreading with liability insurance is considered prudent even when mathematically suboptimal. Only liability insurance can raise the comfort level in the face of these effects.(n322)

The effect of liability insurance on the cost of accidents is not clear. Insurers can help reduce costs by suggesting and insisting upon loss control measures, but in the problem under study the beneficial effect of this monitoring is probably not great.(n323) On the other hand, as noted, insurance carries administrative costs.(n324) In addition, economists speak of the "moral hazard" attaching to the already insured; "[a]n injurer who has liability insurance ... will have a reduced incentive to deter accidents."(n325) Insurance overhead plus moral hazard costs less monitoring benefits is an amount properly assigned to "accident" costs.

Calculating the risk shifting component of PLI is also problematic. If the risks of firm negligence and client insolvency are difficult for auditors to calculate, they are even more difficult for the auditors' insurers. Faced with extraordinary uncertainty because of their limited experience with the new relaxed privity rules and the leveraged balance sheets of many of today's corporations, underwriters will generally be cautious; they will try to err on the high side, especially in the wake of large-stakes lawsuits.(n326) An alternative strategy is for some insurers to drop the professional liability line altogether, perhaps making coverage more expensive because there will be fewer providers. As insurance coverage becomes more costly, passing through its cost in audit fees becomes more difficult.

A perverse counter-approach by some auditors will be to adopt a risk preferring strategy by gambling that their clients will keep their heads above water; that their firms will not be sued; but if sued, will prevail without incurring excessive litigation expense. These firms will "go bare"(n327) or greatly underinsure. Because such firms are unlikely to be able to meet massive third party judgments, they will have succeeded in shifting most of the risk of client insolvency back onto the third parties. Traditionally, such a strategy has been associated with small firms with small clients, but recent financial pressure from litigation experience reported for a number of larger CPA firms, indicates that underinsuring in the present legal (and business) environment has become an inadvertent de facto strategy (n328)

Friction Costs of Litigation

Whenever tort litigation is used as a risk distribution mechanism, the friction costs are high. In personal injury cases, approximately two thirds of liability insurance premiums are siphoned off for litigation costs, primarily attorney fees and administrative expenses.(n329) There is little reason to believe that negligent misrepresentation cases are less expensive.

The higher the stakes to the parties, the more they are likely to invest in the contest itself. Auditors faced with costs attributable to their insolvent clients will spend more on defense to avoid liability altogether than they would if faced with only their equitably apportioned share of the harm. Similarly, plaintiffs and their attorneys who see the possibility of a full and massive judgment will also be prepared to invest more in the litigation process than they would if a smaller recovery were promised. This is especially so because both parties in these disputes perceive that they are struggling in the domain of losses, in which risk seeking has been found to be significantly greater than in the domain of gains, in which risk aversion has been found to be the rule.(n330) When both parties face losses the psychology of risk finds settlement and compromise harder to achieve.(n331) Therefore, when there are insolvent defendants the rule of joint and several liability will increase the stakes in dispute to individual parties and, thus, can be expected to increase the costs of litigation.

Structural Effects of the Joint and Several Rule

One response to lowering the privily barrier has been a vigorous effort to change the law. The state CPA societies have been active in lobbying state legislatures to establish statutory privily requirements in auditor cases.(n332) At this writing, four states have enacted statutes which require third parties, in order to be eligible to sue auditors, to be identified in writing at the time of the audit.(n333) In the judicial arena there seems little doubt that judges have also become aware of, and perhaps influenced by, the accounting profession's public relations and lobbying efforts to slow down the erosion of privily requirements.(n334)

The accounting profession's struggle to maintain this last citadel of privily in tort law is given urgency by retention of the joint and several rule. While insolvent primary defendants are factors in many personal injury cases, in cases involving auditors' liability to third parties, insolvent clients are far more common. Thus, relaxed privily with joint liability dramatically increases the auditor's exposure to damages. As discussed, legal rules that increase potential damages are likely to result in the greater use of PLI.(n335) Liability insurance is not a fungible commodity, however. When risks become both high and eccentric, the larger insurance purchasers have an edge on both rates and availability. There is some likelihood, therefore, that the larger accounting firms will be better positioned to survive in the coming legal environment than the smaller ones. (We take no position on whether a more concentrated accounting profession would be an efficient result, but we doubt that it would be.)

Still another expected effect of heightened liability exposure will be that audits and other examinations will contain more information than is necessary, a response analogous to the practice of defensive medicine. Conversely, more opinions will be qualified when qualification may be unjustified, thus raising capital costs to business.(n336)

It is not at all clear that the purported value of better information for the financial community that might accrue from adopting this combination of legal rules will be worth the extra resources devoted to lobbying efforts, the excessive use of qualified opinions, and a more concentrated accounting profession. Add to this list the additional costs that can be anticipated from heightened exposure to high stakes litigation, and we can conclude that retaining joint liability after adopting the reasonably foreseeable plaintiff rule will likely produce substantial inefficiencies.

The Efficiency of a Reasonable Foreseeability/Several Only Liability Rule

As noted, Landes and Posner would require that injurers fully compensate non-negligent victims in the interest of economic efficiency.(n337) Thus, if there is likely to be an insolvent primary defendant, it is better to have a back-up co-defendant who can be held jointly liable and thus replace the deficiency of the judgment-proof defendant.(n338) Although this result is suboptimal in the "alternative care case" because the co-defendant is a higher cost avoider than the insolvent primary defendant, Landes and Posner state that it is a better result than to rest the entire loss on the innocent victim.(n339)

For the most part we think this argument is persuasive. However, like Landes and Posner, we are not convinced that efficiency requires a non-negligent victim to be fully compensated ex post if contractual mechanisms to shift risk ex ante are not prohibitive.(n340) If a third party creditor, investor, or guarantor knows ex ante that there is a risk that the business to which it trusts its funds may supply it with inaccurate information; that the business's auditor may fail to have the inaccurate information corrected; and that the business may become judgment-proof; the third party can assess that risk and adjust the terms of its loan, guarantee, or investment accordingly. Unlike the victim of a traffic accident or a dangerous defective product, the consumer of uncertain financial information is not powerless ex ante. Although such a party may be nonnegligent, it can be held to have assumed the consequences of a reasonable risk. That is precisely the result of the privity/near privily rule of Ultramares v. Toucher the unknown (to the auditor), albeit foreseeable victim is deemed to have assumed the risk that the business with which it is dealing will become insolvent.

On the other hand, the debacle guarantor-taxpayers have been experiencing with lending institutions indicates that as a third party victim class we have not done an adequate job in assessing the potential for fraud, mismanagement, and misrepresentations of those businesses, nor have we assessed well the probability that accountants might, through negligence, facilitate the dissemination of inaccurate and misleading financial information.(n341) Thus, there remains an arguable need for tort law's sanctions to supplement the corrective powers of financial markets to allocate risk.(n342)

Despite the considerable friction costs of tort law, it is one of our most powerful deterrents. While it does little to deter scoundrels and wastrels who cannot later meet tort judgments, the threat of a lawsuit against solvent ongoing businesses and professional firms does affect their conduct and does induce their taking precautions against accidents. If, however, the judgment threatened is disproportionate to the culpability of the potential tortfeasor (the joint and several rule), the distortions of conduct discussed in the previous subsections can be expected.

We would argue that the more efficient rule would expose an auditor to liability for negligent misrepresentation to reasonably foreseeable third parties, but only to the extent of the percentage of culpability assessed against the auditor at a proceeding in which the conduct of all potential parties is considered, whether solvent or not. This is a pure proportionate several liability rule, or "several rule."(n343) The result, of course, would be to leave some risk with third parties. Inasmuch as that is where the loss falls originally, the refusal to shift some of it through tort law will reduce the friction costs of risk shifting, and by reducing the stakes involved, should reduce the likelihood and expense of litigation.(n344)

Because third parties will bear a higher portion of the risk of negligent misrepresentation under a several rule, they will demand a higher price for their loans, guarantees, and investments. Conversely, parties seeking credit and capital will try to reduce the price demanded by offering more reliable information as an inducement.(n345) The process of acquiring more accurate internal financial information by the credit and capital seeking entity should better enable it to guard against errors and irregularities. Better information, therefore, should translate into fewer defalcations and less diversion of funds to mismanaged enterprises, thus fewer pecuniary "accidents." Because, under a several only rule there will be greater dependence on market forces and less on costly tort litigation reallocations, it would appear to be a more efficient rule than one of joint and several liability.

OTHER LIMITING PRINCIPLES

A number of proposals, other than damage apportionment, have been advanced to ameliorate the exposure of accountants and other professionals to tort liability resulting from suits brought by nonclients. Perhaps the most systematic and comprehensive review of such proposals was conducted in 1988-89 in the United Kingdom by three fact-finding study teams under the chairmanship of Professor Andrew Likierman.(n346) The scope of the study included the liability problems of auditors, professionals in the construction industry, and surveyors. In this discussion, we refer to the conclusions reached by the Likierman team studying the auditing profession(n347) and those of the steering group that coordinated the project.(n348)

In this section we shall consider: 1) limited liability incorporation; 2) further use of contract law ex ante to replace tort in allocating the risk of auditor negligence; and 3) statutory "capping" of liability. Although not limiting principles, we shall also discuss several possible structural reforms of the auditing function because their adoption could affect the need for and efficacy of adopting limiting principles based on law. Each of these topics merits more analysis than can be provided in this article; our purpose in this discussion is simply to present a few troubling issues raised by these proposals.

Limited Liability Incorporation

Certified public accounting firms--in fact, firms practicing most professions -- are either sole proprietorships, partnerships, or professional corporations. In all three cases, the principals retain considerable exposure to personal liability for torts committed in professional practice. The option of general incorporation with limited personal liability is denied by state law, and, until recently, has been forbidden by the ethical pronouncements of the accounting profession.(n349) In 1991, however, the AICPA moved to remove the prohibition against general incorporation, when and if state law permits accountants to limit their vicarious personal liability in line with shareholders under general corporation laws.(n350)

The AICPA pronouncement appears to be in contemplation that, in some states at least, the laws of general incorporation will be made available to professionals. We are less sanguine. Professional firms are not capital intensive. The personal estates of the professionals will, we think, always represent back-up funds (to meet judgments) that state legislatures are likely to insist on preserving in the absence of greatly tightened regulation that would include adequate professional liability insurance coverage.(n351) With recent shakiness in the insurance industry, even liability coverage is likely to be viewed by legislators as insufficient protection.(n352)

Perhaps the principal reason that limited personal liability has been accepted by modern governments and has endured is because it made possible the formation of large entrepreneurial organizations capable of undertaking great projects having high social utility. This was so because, without this protection, investors would be reluctant to risk their entire personal fortunes to the administration of strangers.(n353) It is doubtful, however, that lawmakers will find the equivalent utility in accelerating the growth of professional firms by granting the partners complete personal protection from their firms' judgment creditors.

The Likierman auditors' study group supports incorporation of accountants as "limited companies" stating that it "would put the auditors on a similar footing to most of those with whom they deal."(n354) We think that the point is that auditors should not be put on the same footing with their corporate clients. Every effort should be made to enhance the credibility of the audit opinion. An unqualified opinion backed by the personal assurances of the auditors is far more likely to enhance that credibility, especially in these days of gigantic multinational accounting firms with thousands of partners.

After voicing its support for limited liability incorporation, the study group had second thoughts:

It is not clear whether the overall effects of a catastrophic claim against a company would be significantly less drastic than the effects of a similar claim against a similar partnership. Although the principals would not be personally bankrupted, the company would be wound up and they would lose their investment and their jobs (n355)

The group apparently concluded that general incorporation offers the auditing profession only marginal relief. The group members may well have been thinking that the tradeoff of personal protection for auditors against the loss of professional credibility that would accrue from limiting their personal liability may not be worth the candle.

The Full Reliance on Contract Approach

Professor Richard Epstein has pointed out the difficulties in assessing the auditor's risk in a world without privily: "[W]ithout the privily limitation the accounting firm finds it more difficult to estimate the potential exposure for any possible losses."(n356) This is so because, "if the use of the audit statement is not fixed or known in advance, it will be difficult to estimate the proper fee."(n357) The difficulty is exacerbated by the uncertainty of the negligence standard and the subsequent "costs of error and litigation."(n358)

Epstein advocates looking to the law of consequential damages in commercial contracts. "These clauses tend to avoid having liability turn on the matters of degree that are the hallmark of negligence. Instead a frequent commercial pattern is to have a strict system of liability coupled with very limited damages."(n359) Given that third parties are "sophisticated" and can insure and make their own financial tests, he believes that all the parties affected by the audit contract would choose to allocate misrepresentation risks by contract. In a world in which no-privily-for-third-parties were the default rule, this result would have to be achieved by the use of unnegotiated disclaimers and limitations of remedy prominently displayed on the audit statements --unnegotiated because actual negotiations between the auditor and unidentified third parties are by definition not possible.

If one assumes that courts would assign high priority to the public duty of auditors, it seems unlikely that they would enforce the disclaimers and remedy limitations.(n360) But if these provisions were enforceable, it is likely that financial markets would tend to overcompensate for the risks these disclaimers seek to shift. Creditors and investors faced with auditors' exculpatory language would be unlikely to give the audit opinion the credibility to which it may in fact be entitled. The "clean opinion" backed up by a lack of exculpation is what clients and third parties generally seek. Anything less raises a red flag. One reason the large, prestigious accounting firms are traditionally sought for audits is the dollars and cents credibility their unqualified opinions bring to their clients.(n361)

The AICPA also recognizes the psychological value of uniformity. Its pronouncements require the unqualified opinion to be rendered in standard form and language.(n362) Any qualifications also must follow a standardized format. It is unlikely that varying forms of disclaimers of liability and limitations of remedy would be countenanced by the profession -- and for good reason: they would be greeted with great suspicion by all users of financial information. Standardized disclaimers and remedy limitations might catch on over time, but without legislative approval,(n363) courts would certainly give them close scrutiny and would certainly find them questionable on public policy grounds.

The Likierman Report notes that British auditors are precluded by statute from limiting liability to their clients,(n364) although, theoretically, other professionals could.(n365) With respect to the non-auditors, however, the Report suggests that "the effectiveness of such disclaimers can be doubtful because of the uncertainty of whether the terms might fall under the Unfair Contract Terms Act 1977."(n366) Subsequent cases interpreting the 1977 Act's statutory phrase "unreasonable restrictions on liability for economic loss" would appear to confirm those doubts.(n367) It seems likely that a similar result would be obtained judicially in the United States.

Victor Goldberg(n368) develops the contract approach from the perspective of a total privily rule, a sort of Ultramares plus regime in which third parties are precluded from suing auditors even for fraud.(n369) Under such a regime, third parties seeking assurances from auditors would have to negotiate and presumably pay for these undertakings either directly by negotiating a contract of indemnity with the auditor or indirectly by demanding some sort of surety bond from the client that would indemnify specifically identified losses caused by auditor negligence or fraud.(n370) Goldberg acknowledges that neither auditors nor third parties are likely to initiate such contract negotiations very often. He attributes this predicted lack of enthusiasm to the conclusion that auditors are "not very good guarantors" and "would rarely agree to compensate third parties,"(n371) and that third parties are likely to prefer a host of more direct and traditional assurances from the auditors' clients.(n372)

Goldberg points out, as do we, that audit failure can be subsumed into the total risk equation third parties make before parting with their money, and against which they can protect themselves by insisting on risk premiums. So what role remains for tort law's ex post "guarantee" against auditor negligence? Only one, deterrence. But why should this be necessary if as Professor Goldberg notes, "In the half century following Ultramares, businessmen did not successfully design a guarantee that compensated some classes of losers in the event of an accountant's negligence being associated in some way with their losses"?(n373) By "guarantee," Goldberg is referring to the tort remedy that would have been provided to third parties injured by auditor negligence, if it were not for the privity barrier that businessmen saw fit to retain for fifty years.

The answer, we think, is that times change. Goldberg, writing in 1988, thought that the necessity of protecting the accounting firm's brand name was a powerful and adequate deterrent against the firm's production of negligent audits. We think that there is at least the perception in financial markets that the incentives of tort law are now appropriate when once they may have been unnecessary.

In terms of economic efficiency, the issue is whether the benefits of the lower cost of capital derived from providing third parties with a tort remedy "guarantee" supplied by the auditor are outweighed by increased tort litigation costs under a no-privily rule. The solution to this equation is not immutable. The incentives (or temptations) for negligent audits can vary with conditions in the market for auditing. The market seems to be telling us that fifty years of experience is not dispositive -- there are such things as historical sea changes and watersheds. Changes in liability rules often derive from public reaction to dramatic increases in incidents of injurious conduct. The main thrust of this article is that there is a danger in overreacting to perceived defects in the current auditing environment.

But given the increasing conflict of interest pressures flowing from the American auditor-client relationship (which we detail elsewhere in this article),(n374) the increase in business failures, and the explosive growth of third party suits against even prestigious "brand name" auditors, we think the call for a return to the privily citadel will and should ultimately be rejected.

Statutory Caps on Tort Liability

There has been considerable experience in the United States with statutory caps on tort damages.(n375) Some of the statutes have provided for specific dollar caps on total recovery whether the damages are economic or noneconomic.(n376) A few take into consideration factors such as severe injury or disfigurement, inflation, average annual wage, and life expectancy.(n377) Others, especially those enacted more recently, limit only noneconomic damages.(n378)

Noneconomic damages are frequently defined as "pain, suffering, inconvenience, physical impairment, and other nonpecuniary damage."(n379) There would appear to be three reasons for limiting this component of a victim's judgment: first, there is the widespread belief that evaluating these injuries must always be speculative and thus open to abuse and prejudice; second, it is not clear that pain and suffering represents a social loss that must be fully compensated in the interest of economic efficiency; and third, noneconomic damages represent the lion's share of many personal injury judgments, thus, controlling these awards is an effective form of tort reform. The damages flowing from auditor negligence, of course, would be almost wholly economic.

A number of the cap statutes, primarily medical malpractice damages caps, have been challenged under both state and federal constitutions.(n380) The specific grounds for these challenges have been the alleged grant of special privileges or enactment of special laws,(n381) or the failures to provide equal protection,(n382) due process,(n383) a remedy for wrongs,(n384) access to the courts,(n385) or an effective right to a jury trial.(n386) One recent decision claims that more of these challenges have been successful than not.(n387)

The medical malpractice scenario is generally quite different than that of third party claims against auditors. There is usually a single victim of medical malpractice, whereas third party victims of negligent auditing can be a broad class. When there is a class, it would have to be determined whether the cap would represent a single fund to be allocated to individual claimants, whether the cap should be applied to each individual claim, or whether both types of caps should be employed.(n388)

The principal justification for caps on auditors' liability, we think, is that auditors are relatively minor players in the scenarios that give rise to massive losses.(n389) Their "take" from the enterprises they audit is limited to a fee based on time spent in the engagement. Inasmuch as their gain is limited, arguably, so should their liability be limited. The third party who has suffered extensive loss, however, will argue that this result would be unfair because those with small losses might recover fully, while larger claims would be less than fully satisfied.(n390)

A statutory cap system for auditors was proposed for Australia in 1987.(n391) The proposal linked the maximum auditor's liability "to all persons" to a sliding scale based on the audit fee.(n392) This scheme impliedly recognized that there is a legitimate connection between the auditor's gain and her liability exposure. The proposal included a requirement to carry adequate insurance based on historical fee experience, and it provided for unlimited liability in the event of willful conduct.(n393)

The authors are receptive to the idea of statutory damage limitations. We think that United States tort law with respect to liability has been, on the whole, well developed; but we feel that our damages law is out of control. Although we can see the justification for assuring full compensation in the case of physical injury, we find such relief for pecuniary loss less compelling. This is particularly true for large losses. When an investor or creditor ponies up a large stake for an enterprise, he is on notice that special precautions are in order. If he is content to rely entirely on management's audited financial statements, he had better be prepared for serious risk sharing. On the other hand, a smaller investor or creditor is not as economically well positioned to make independent financial investigations - thus, there is a "rational basis" for a classification system that promises greater legal protection for smaller stakes than larger ones.(n394)

Having voiced support for something akin to the Australian plan, we are doubtful that the scheme has much of a future for the short term in the United States. Damage limitation proposals have met determined opposition in the medical malpractice area and are likely to meet similar resistance in this one. When state legislatures have been persuaded that insurance crises exist, the courts have found a surprising number of grounds for declaring damage cap legislation, even for noneconomic damages, to be repugnant to constitutional guarantees. One could anticipate that the economic damage caps proposed for auditor liability would be even less likely to pass constitutional muster. If there were some way to trade existing accountants' privily-barrier protections for damage-limitations, that might make practical sense, but it is not how the law is likely to develop.

Structural Reform

Although one can rarely state authoritatively in many individual cases that auditors were influenced to overlook their clients' errors or irregularities for fear they might be replaced by less scrupulous competitors, it is clear that the temptation exists.(n395) If it is assumed that competition for audit fees and management advisory services contributes to the frequency of litigation involving auditors, then implementing reforms that would reduce this competitive environment presumably would reduce the urgency of finding legal principles to limit liability.

In the ideal case, auditors would be appointed and rotated by someone other than the insiders of the company (i.e., management, board of directors, stockholders, etc.).(n396) This would probably be a task for the SEC or an analogous body at the state level. We would recommend additionally the prophylactic rule that appointment be by lottery from a long list of statutory auditors.(n397) Clearly, the list would have to be broken down into subgroups of accounting firms that have the resources to audit companies of various sizes and types. Again, ideally, statutory auditors would be permitted to do nothing else professionally but conduct audits.

Companies would be free to hire accountants as advisors, advocates, tax planners, and management consultants, but these would be different accountants than the statutory auditors. This proposal tracks with the French system.(n398) Audit fees would be regulated, either on a per hour basis or some other indicator such as client size. If there are special problems that could justify larger fees, pre- or post-engagement arbitration would be one way to handle the problem.

In the actual, less-than-ideal-world, a major step would be to preclude accountants from offering non-audit services to their audit clients. This proposal parallels the Japanese and British systems.(n399) It would also be helpful if the highest possible "chinese walls" would be erected in the large firms that would keep auditing and advisory divisions as separate as possible. Aside from reducing conflict-of interest problems, such an organizational structure might prove to be good business.(n400) (Consulting and auditing divisions of accounting firms might then be successful in signing up competitors of the other division's clients.)(n401)

So that auditor turnover could be tolerated with minimal learning curve problems, greater efforts (through legislation or FASB rules) should be made over time to standardize accounting methods, forms, statements, and procedures as was accomplished in France.(n402) Such an initiative would also make it easier for unsophisticated users of financial information to understand and compare the data they receive.

Although the above proposals seem reasonable and probably would be in the accounting profession's best long term interests, they are unlikely to be seriously considered in the foreseeable future; the synergy of providing a multitude of loosely related services including auditing --the service that gets the firm in the door -- is simply too attractive to be abandoned.

Even though abuses might flow from the present state of affairs, the accounting profession probably has the clout, the resources and the inclination to preserve the status quo.

CONCLUSIONS AND RECOMMENDATIONS

We find it difficult to justify a privity requirement for maintaining negligence actions against auditors when privity is no longer required in actions against other negligent tortfeasors. Although at one time the relaxation of privity was justified to let only physically injured individuals reach the principal tortfeasor, the controlling foreseeability principle has proven sound and worthy of universal applicability in negligence cases.

On the other hand, the common law rule of joint and several liability cannot be justified on fairness or economic efficiency grounds in a number of areas, especially if the victim of negligent conduct has suffered only pecuniary loss and can negotiate the risk of insolvency ex ante. In third party claims against negligent auditors, the reasonably foreseeable plaintiff should have standing to sue, but the culpability of the auditor should be assessed by the fact finder and only that equitably apportioned share should be imposed on the auditor, whether or not potential joint defendants are insolvent or immune from suit.

Given the right of reasonably foreseeable or foreseen non-client plaintiffs to sue auditors for negligence, we support, in theory, the idea of statutory caps linked with fee size. We also approve of various structural reforms that aim to remove conflict-of-interest problems from the client-auditor relationship. We are doubtful, however, that either of these proposals will soon be considered seriously, let alone adopted in this country.

We do not support the full-reliance-on-contract approach, believing that unnegotiated disclaimers of liability and limitations of remedy that have no legislative base of support (such as the Uniform Commercial Code) are unlikely to be enforced by many courts on public policy grounds and will add a note of increased variability in an area that requires more standardization than now exists. We also think that a return to a privity regime, depending on negotiated indemnity contracts and brand name protection to inhibit negligent auditing, will provide inadequate deterrence in the current cutthroat competition for auditing engagagements. Our position is predicated on the assumption that courts, legislatures, and financial markets will ultimately agree with this assessment, but in this regard our crystal ball could easily turn out to be clouded.

Finally, we do not support the idea of limited liability incorporation for accountants. Historically, the corporate form with liability limitation prevailed because it proved to be a device that could increase organizational size in order to facilitate the undertaking of great projects. A lack of these imperatives would appear to make the grant of limited personal liability unnecessary and inappropriate for the professions.

To sum up, the authors recommend apportionment of damages as the main principle limiting the liability of negligent auditors to foreseeable third parties. We also urge that the rule of joint and several liability be abrogated, at least in cases in which the trier of fact assigns the auditor a relatively low percentage of culpability. We advocate a proportional several only rule be adopted for those cases on the grounds of equity and economic efficiency.

We cannot predict whether adoption of this proposal will provide much relief for the accounting profession; juries, after hearing evidence and argument may consistently choose to assess high percentages of fault against negligent auditors. But, under this rule, auditors can be assured of having their full day in court: they will be permitted to argue that their culpability--if any--is less than the totality of the plaintiff's damages, and, as a result, they should be required to pay no more than their proper share of those damages.(n403)

(n1) 425 U.S. 185 (1976).

(n2) 48 Stat. 891, 15 U.S.C. Section 78j(b) (1981) [hereinafter 1934 Act]. The implementing regulation for Section 10(b) is Rule 10(b)-5, 17 C.F.R. Section 240.10b-5 (1991).

(n3) 425 U.S. at 193. The Court analyzes the language of Section 10(b) which "makes unlawful the use or employment of 'any manipulative or deceptive device or contrivance in contravention of Commission rules" and concludes that the SEC is incorrect when it argues that the above language does not limit the rule's operation to knowing practices. Id. at 197-98. The Court finds support for equating the prohibition of manipulative devices and contrivances exclusively with the scienter element in the legislative history of the 1934 Act. Id. at 201-14.

(n4) Misfeasance or negligent performance of a contract -- in this case, a contract of audit engagement -- has long been actionable as a tort under common law, but it is said that "the duty is an incident of the relationship rather than the contract." W. PACE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 660 (5th ed. 1984) [Hereinafter PROSSER & KEETON]. However, "the American courts have extended the tort liability for misfeasance to virtually every type of contract where defective performance may injure the promissee." Id.

(n5) A third party's reliance on the audit opinion would be necessary to establish that the auditor's negligence proximately caused the plaintiff's loss. Presumably, something more than the third party's knowledge that an unqualified audit opinion existed would be required to establish proximate cause. A trade creditor, for example, would probably have to show that its credit department had reviewed the financial statements in some detail before recommending that the auditor's client be advanced a line of credit. See Lee Berton and Stephen Adler, How Audit of a Bank Cost Price Waterhouse $338 Million Judgment, WALL ST. J., Aug. 14, 1992, at A1 (noting that an important issue on appeal of this massive jury verdict will be whether the non-client plaintiff's Chief Financial Officer had relied on the defendant's audit opinions: "Other than his testimony, there was no proof he had relied on the audits.").

(n6) The rule was first enunciated in Ultramares v. Touche, 174 N.E. 441 (N.Y. 1931). See infra notes 10-14 and accompanying text. States following this restrictive privily approach through judicial adoption are Colorado, Idaho, Indiana, Nebraska, and New York. See Paul J. Herskovitz, Auditors and Third Party Negligence Suits: Judicial Approaches and Legislative Reforms, OHIO C.P.A. J. 20, 21 (Winter 1990). (for Colorado and Indiana, federal courts sitting in diversity have predicted this position). Pennsylvania has adopted a privily only approach, but federal courts disagree whether the early Pennsylvania ease will be followed. Id.

Four states have reached the Ultramares position through legislation: Illinois, Utah, Arkansas, and Kansas. In the Kansas statute, KAN. STAT. ANN., Section 1-402 (Supp. 1987), a third party can recover if the auditor is aware of its reliance and the party has been identified in writing to the auditor and the specific transaction described. The Illinois statute, Ill. ANN. STAT. ch. 111, 5535.1 (Smith-Hurd Supp. 1987), the Utah Statute, UTAH CODE ANN. Section 58-26-12 (1990), and the Arkansas statute, ARK. CODE ANN., Section 16-114-302 (Michie Supp. 1987), all provide that the auditor can limit its negligence liability to those third parties the auditor identifies in writing to the client.

(n7) The typical scenario involves both trade and financial creditors demanding proof in the form of audited financial statements of a potential debtor's ability to pay. Although the source of the financial information is the business that is seeking credit, the attestation to the information's material accuracy derives from the supposedly rigorous independent audit by outside accountants.

(n8) Creditors seeking additional assurance may demand third party guarantees or may offer inducements in the form of reduced interest if guarantors will sign on the obligations. Presumably, guarantors who rely on audited statements should have a direct right, or a right of subrogation, to sue negligent auditors if the creditors have such rights. See, e.g., Maduff Mortgage v. Deloitte, Haskins & Sells, 779 P.2d 1083 (Or. Ct. App. 1988). In the ease of insolvent savings and loan institutions, the United States government, which acts as a guarantor of the S&L's obligation to depositors (or, more accurately, as a back-up guarantor of the former FSLIC), has moved vigorously under the statutory guarantee to recover its losses from various parties associated with the defunct S&L's including their auditors. Although most of these suits involve allegations of fraud for which defendants have little or no privily protection, suits in negligence are also being maintained by the United States. In general, however, these suits are not brought as third party suits, although we believe they could be. See infra note 186 and accompanying text.

(n9) The status of investors to sue auditors for negligent misrepresentation is somewhat more ambivalent than that of creditors and their guarantors. If the form is corporate, investors are stockholders and thus own the auditor's "client." As noted, infra note 28, the client is the source of the financial information that is audited for accuracy and fairness by the outside accountants. If the information proves to be materially inaccurate, the corporation can sue the auditor for misfeasance or malpractice for negligently failing to discover that the information the corporation provided was false. Presumably, the individual owners of the corporation can also sue the auditors for personal capital losses incurred in reliance on audited financial statements, if, of course, privily rules in the jurisdiction so permit.

(n10) 174 N.E. 441 (N.Y. 1931).

(n11) If liability exists, a thoughtless slip or blunder ... may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences. Id. at 444.

(n12) 111 N.E. 1050 (N.Y. 1916).

(n13) "[W]hat is released or set in motion [in MacPherson] is a physical force. We are now asked to say whether a like liability attaches to the circulation of a thought or a release of the explosive power resident in words." 174 N.E. at 445.

(n14) See Denzil Y. Causey, Jr., Accountants' Liability in an Indeterminate Amount for an Indeterminate Time to an Indeterminate Class: An Analysis of Touche Ross & Co. v. Commercial Union Ins. Co., 57 Miss. L.J. 379, 380-82 (1987).

(n15) 3 RESTATEMENT (SECOND) OF TORTS Section 552 (1977).

(n16) Id. (2)(a).

(n17) A recent survey found 16 states that follow, or were predicted to follow, the Restatement position. See Herskovitz, supra note 6, at 25. Jurisdictions are currently confronting this issue quite frequently and the compromise Restatement position is likely to be the most popular one for awhile.

(n18) See Francis Achampong, Common Law Liability of Accountants for Negligence to Non-Contractual Parties: Recent Developments, 91 DICK, L. REV. 677, 684 (1987) (citing Rusch Factors--Inc. v. Levin, 284 F.Supp. 85, 92-93 (D.R.I. 1968).

(n19) 320 P.2d 16, 19 (Cal. 1958).

(n20) See, e.g., Aluma Kraft Mfg. Co., v. Elmer Fox & Co., 493 S.W.2d 378 (Mo. Ct. App. 1973). Later, in Lindner Fund v. Abney, 770 S.W.2d 437 (Mo. Ct. App. 1989), the court clarified that third parties, in order to recover, must belong to a limited class of foreseeable plaintiffs. "The purpose of the rule in Aluma Kraft ... is to prevent accountants from being held liable to the public at large." Id. at 438.

(n21) See Aluma Kraft Mfg. Co., 493 S.W.2d at 383.

(n22) See H. Rosenblum v. Adler, 461 A.2d 138 (N.J. 1983); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361 (Wis. 1983); Touche Ross & Co., v. Commercial Union Insurance Co., 514 So. 2d 315 (Miss. 1987)i Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408 (Text Ct. App. 1986). Arizona could soon be joining this list. See Berton and Adler, supra note 5 (noting that in action against Price Waterhouse, the trial judge "instructed the jury that the firm could nonetheless be liable ... if it was 'reasonably foreseeable' that an acquirer . .. would rely on Price Waterhouse's audits.") (emphasis added).

See also International Mortgage Co. v. John P. Butler Acct. Corp., 223 Cal. Rptr. 218 (Cal. Ct. App. 1986) overruled by Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992). For six years controlling California law on the issue of auditor liability to third parties was the Butler decision, which tracked closely with the reasonably-foreseeable-plaintiff position of H. Rosenblum v. Adler, 461 A.2d 138 (N.J. 1983). In the wake of enormous, recent, national verdicts against CPA firms performing audits, the California Supreme Court, in Bily, weighed in with a 5-2 decision that now places California in the group of states which purport to apply the Restatement (Second) of Torts Section 552 in negligent misrepresentation cases. Bily at 768-73. The supreme court's interpretation of the Restatement is a narrow one as indicated by the following negligent misrepresentation instruction the supreme court suggested be used henceforth by California trial courts.

The representation must have been made with the intent to induce plaintiff, or a particular class of persons to which plaintiff belongs, to act in reliance upon the representation in a specific transaction, or a specific type of transaction, that defendant intended to influence. Defendant is deemed to have intended to influence [its client's] transaction with plaintiff whenever defendant knows with substantial certainty that plaintiff, or the particular class of persons to which plaintiff belongs, will rely on the representation in the course of the transaction. If others become aware of the representation and act upon it, there is no liability even though defendant should reasonably have foreseen such a possibility.

Bily at 772 (emphasis added).

Although the restoration of a more restrictive privily rule will provide a temporary respite for CPA firms from pending litigation, it is unlikely to be much of a long-term solution, inasmuch as third parties are sure to learn how to become members of the protected class of "foreseen plaintiffs" in negligent misrepresentation suits against professionals. See infra text accompanying note 27.

(n23) It could be argued that, even under restrictive privily rules, an auditor remains indirectly exposed to liability because its client, who becomes liable to creditors, investors, and guarantors, will have a right of contribution or indemnity (or a separate professional negligence claim) against its auditor who failed to detect and report internal fraud or other dubious transactions. See Suzanne Whoolley & Zachary Schiller, These White Shoes Are Splattered With Mud, BUS. WK., Sept. 7, 1992 (reporting lawsuit by Phar-Mor Inc. against its auditor Coopers & Lybrand for negligence in failing to uncover an alleged $10 million embezzlement and $350 million overstatement of net worth by Phar-Mor employees that led to the collapse and bankruptcy of the company). Frequently, however, the directors and managers of those companies were either aware of, or responsible for, the misconduct and may, for that reason, be barred from bringing such suits. See Sontag, infra note 186. But see also Lambert, infra note 186 (reporting that recent 9th Circuit decision gives FDIC broadened powers to maintain such suits in its role as receiver of failed thrifts).

(n24) See, e.g., H. Rosenblum v. Adler, 461 A.2d 138 (N.J. 1983).

(n25) See, e.g., Christy Harlan, Jury Awards $500 Million in Damages To Ex-Bondholders in MiniScribe Case, WALL ST. J., Feb. 5, 1992 at A3 (reporting that auditors Coopers & Lybrand were assessed $200 million punitive damages for negligence out of a $550 million award, which included only $20 million in compensatory damages; the balance of $330 million in punitives was assessed against the client's former chairman, and one of its investment banks).

(n26) 461 A.2d 138 (N.J. 1983).

(n27) The role of accounting firms in the S&L crisis has received considerable attention in the press. See, e.g., Accountants Under Siege, A.B.A. J., Jan. 1991, at 20; Arbitration in FDIC Against Accountants Yields Small Recovery, WALL ST. J., Mar. 8, 1991, at B8; Eric N. Berg, The Lapses by Lincoln's Auditors, N.Y. TIMES, Dec. 28, 1989, at D1; Lee Berton, Spotlight on Arthur Young Is Likely to Intensify as Lincoln Hearings Resume, WALL ST. J., NOV. 21, 1989, at A20; Lee Berton, Friendly Watchdog, An S&L in California Dumped Peat Marwick for Congenial Auditor, WALL ST. J., May 10, 1989, at A1; Lee Berton, Big Accounting Firms Face Ban in S&L Bailouts, WALL ST. J., Mar 14, 1990, at A3; Weston Kosova, Cranston Wiggling, THE NEW REPUBLIC, Mar. 13, 1990, at 25; Sherry P. Sontag, Soured Deals Snag More Professionals, NAT'L L.J., Feb. 4, 1991, at 1; Paulette Thomas & Stephen J. Sansweet, Ernst & Young Agrees to Pact on S&L Work, WALL ST. J., Feb. 7, 1991, at B5; Marc Tucker & Jay Eisenhofer, Negligent Representation Suits Multiply in Wake of S&L Crisis, NAT'L L.J., Jun. 25, 1990 at 17; Steven Waldman, The Other S&L Culprits, NEWSWEEK, Oct. 29, 1990; at 54; Leslie Wayne, Where Were the Accountants?, N.Y. TIMES, Mar 12, 1989, at F1; Stephen Wermiel, High Court Refuses to Hear Challenge of Regulators' Thrift Cleanup Tactic, WALL ST. J., Mar. 26, 1991, at B10.

(n28) Auditors attest to the material accuracy of financial information supplied by their clients. When the information is materially misstated (which would include material omissions) in the audited financial statements, the fault can lie with the corporate client; corporate officers and directors) corporate employees; the client partnership or sole proprietor (if it is not a corporation); independent contractor professionals such as appraisers, attorneys and the like; and, of course, the outside auditor. All or some of these parties might have acted with scienter, or negligently, or non-negligently. This article confines itself primarily to the case where the auditor is negligent, where the third party is non-negligent, and one or more of the other entities listed has also acted negligently and/or fraudulently.

(n29) See infra notes 287-331 and accompanying text. See also infra text accompanying note 371.

(n30) See GARY J. PREVITS & BARBARA D. MERINO, A HISTORY OF ACCOUNTING IN AMERICA 129 (1979).

(n31) Id. at 130.

(n32) In 1900 Henry Clews, President of the New York Stock Exchange, noted that, "while financiers were interested in production, they were at least as interested in profits from issuing securities and arranging mergers and acquisitions." Id. at 129 (quoting HENRY CLEWS, THE WALL STREET POINT OF VIEW (1900)). As a result, Clews was, as early as 1890, "an avid proponent of publicity of corporate accounts." Id. at 130.

(n33) "[T]he vast majority of contemporary reforms did not advocate, and most of them specifically opposed, a direct federal intervention in or regulation of the financial affairs of corporations." Id. However, there was a minority view that favored governmental audits, a view expressly rejected by the Congress. Id. at 191 n.4.

(n34) Id. at 132.

(n35) Id. at 135-36.

(n36) Elijah Watt Sells, a leading accounting practitioner at the turn of the century stated that, "it is an unassailable truth that any one of the men who stand at the heart of our great business institutions is far more competent to run the government, and would run it more economically, more wisely, and more honestly than any of those who are in the business of running government." Id. at 137 (quoting ELIJAH SELLS, CORPORATE MANAGEMENT COMPARED WITH GOVERNMENT CONTROL (1908)). Sells's pamphlet was commended by Oliver Wendell Holmes. Id.

(n37) See id. at 131 for a short description of "The Progressive Movement." The authors point out that the movement "did not articulate a single unified philosophy nor did all progressives embrace a single common cause. There were in fact several progressive movements which are often combined and described as `the quest for social justice.'" The movement called for an active governmental role in defining social goals but stopped short of calling for operational control of business. Id.

(n38) Id. at 136-37.

(n39) See id. at 139-42 for the history of the early influential state societies of New York, Pennsylvania, and Illinois.

(n40) Id. at 142-56.

(n41) According to Previts and Merino, World War I was a watershed event which brought "a widespread belief that business had reformed and that no external regulation was necessary, [and that] the accountants, role changed dramatically from protector of third parties to conserver of the interests of business, a change that did not have salutary effects on the development of the profession." Id. at 197.

(n42) Id. at 201.

(n43) CPAs not only donned the mantle of "infallible advisor to the client," during this period, they could actively represent those clients on tax matters in court. Id.

(n44) Id. at 202.

(n45) Id.

(n46) Id.

(n47) "[P]ublic accountants now constitute a skilled professional class, and are subject generally to the same rules for liability for negligence in the practice of their profession as are the members of other skilled professions." Smith v. London Assurance Corp., 96 N.Y.S. 820, 820 (1905).

(n48) PREVITS & MERINO, supra note 30, at 202 (quoting from unidentified 1918 case).

(n49) 208 N.Y.S. 259 (N.Y. App. Div. 1925), aff'd, 152 N.E. 431 (N.Y. 1926).

(n50) See infra notes 165-66 and accompanying text.

(n51) 174 N.E. 441 (N.Y. 1931).

(n52) Id. at 449. In fact, the auditors' omissions were held to be fraudulent misrepresentations. Id.

(n53) Id. at 447.

(n54) Accountants in the 1920s did debate the financial treatments of items like surplus and no par stock that were particularly subject to manipulation by business. A major critic of the acceptance of the prevailing treatment was William Z. Ripley. Ripley suggested that the FTC should "provide guidance and leadership in improving financial reports and regulating corporate business." PREVITS & MERINO, supra note 30, at 236. But given the pedestal upon which the businessman perched in the 1920s, it was highly unlikely that the FTC (or any other governmental body) was then prepared to lead "a crusade to protect the investor." Id. More important was the apparent "casino' environment in the market and that no amount of information could have dampened the sincere belief of many that indeed the millennium had come and everyone ought to be rich. Id. (citing F.L. ALLEN, ONLY YESTERDAY (1931)).

(n55) The establishment of the SEC in 1934 did not lead to "draconic accounting rules that would significantly circumscribe the use of professional judgment." Id. at 244. Rather, the emphasis was on "full disclosure," allowing auditors to accomplish that objective as they saw fit. Some studies have advanced the theory that full disclosure would not have prevented the crash because it has never been established that investors prior to 1929 actually received inadequate information. Id.

(n56) Prior to 1929, the Exchange refused to acknowledge the need for independent audits. Id. at 205. "Only after the crash did accountants receive the full support of the exchange." Id. at 205 & n.8 (citing editorials in 1924, 1925, & 1926 in the Journal of Accountancy).

(n57) Audits belong in the category of attest services performed by CPA firms. There are numerous services that can be provided by CPAs and many of these services are guided by different standards. Attest services are one category which includes audits, reviews, special-purpose reports, and prospective financial statements. (CPAs also offer accounting, tax, and consulting services to their audit clients as well as to other clients who do not use their attest services.) What follows is a description of the principal attest services.

Audits: The most important and relevant attest service to this article is auditing: "Auditing is the process by which a competent, independent person accumulates and evaluates evidence about quantifiable information related to a specific economic entity for the purpose of determining and reporting on the degree of correspondence between quantifiable information and established criteria." ALVIN A. ARENS AND JAMES K. LOEBBECKE, AUDITING: AN INTEGRATED APPROACH 2 (5th ed. 1991). In other words, auditing emphasizes the determination of whether the recorded financial information of an entity properly reflects the economic events that occurred during the accounting period. The outcome of the independent audit engagement is the issuance of the audit report. This report states the opinion of the CPA or CPA firm as to the fairness of presentation of the entity's financial statements under audit. The benchmark used to evaluate the fairness is Generally Accepted Accounting Principles (GAAP). GAAP is codified in numbered pronouncements and statements published by the Financial Accounting Standards Board (FASB) and its predecessors. The FASB is an independent standards setting organization established by the accounting profession in the early 1970s. See 1 ORIGINAL PRONOUNCEMENTS, Accounting Standards, FASB Statements of Standards (Fin. Accounting Standards Bd. 1990). The audit opinion represents the positive assurance of the CPA regarding the fairness of the financial statements, which includes the financial health of the entity being audited.

Generally Accepted Auditing Standards (GAAS) are the minimum standards that an auditor must follow in conducting an audit engagement. The codified GAAS is issued by the AICPA and are general in nature; nevertheless, they are enforceable. See 1 AICPA PROFESSIONAL STANDARDS, U.S. Auditing Standards (Am. Inst. of Certified Pub. Accountants (CCH) 1990). Along with GAAS, the auditor relies on other professional pronouncements by the AICPA. For auditing, these professional pronouncements are called the Statements on Auditing Standards (SASs). Id. all sections, at 51-2343. The SASs give more specific guidance, including examples, to CPAs regarding the conduct of audit engagements. However, the SASs are not intended to usurp auditor judgment which is paramount to the execution of a specific audit engagement. Yet, typically during lawsuit proceedings, reference will be made to compliance with GAAS and the SASs. See WANDA A. WALLACE, AUDITING 235-36 (2d ed. 1991).

The SASs discuss a multitude of topics, including the types of: (1) audit reports that can be issued; (2) evidence that can be collected; (3) audit procedures that can be performed; and (4) audit tools that can be used. Nevertheless, the SASs do not cover all issues that an auditor may encounter on a given audit engagement because new accounting issues are always emerging. In addition, the SASs do not tell the auditor specifically what to do for a particular set of client circumstances. These decisions are left to the individual auditor based on his or her professional judgment. However, there are common audit procedures that are performed in many audit engagements. For example, the SASs indicate that auditors should observe the client company's physical inventory when those inventories are considered material to the client's financial statements. 1 AICPA PROFESSIONAL STANDARDS, U.S. Auditing Standards, AU section 331, at 331-33 (Am. Inst. of Certified Pub. Accountants (CCH) 1990). Likewise, the SASs recommend that the auditor should confirm the client's accounts receivable with customers if accounts receivable are considered material. Id. Nevertheless, this testing, as well as most of the auditor's testing, is done on a sample basis which requires that the auditor examine only a portion of the population of interest.

In Bily v. Arthur Young & Co., 271 Cal. Rptr. 470 (Cal. Ct. App. 1991) rev'd on other grounds, 834 P.2d 745 (Cal. 1992), one issue was whether an auditor that had followed GAAS could be held liable to a third party for negligent misrepresentation. The court stated:

Under the general rule GAAS and GAAP, as compilations of custom and practice will be relevant and thus admissible as 'evidence to be considered in determining the proper standard of care' [citation ommitted] and in many if not most cases an accountant who has complied with GAAS and found compliance with GAAP will be found, in turn, to have satisfied the applicable standard. But this is not to say that GAAS and GAAP define the the standard of care. Certified public accountants ... must meet the standards of expertise and diligence common to their profession as proved with respect to the facts of particular cases by the testimony of suitably qualified expert witnesses.

Id. at 475-76 (emphasis in the original). Accord Maduff Mortgage v. Deloitte, Haskins & Sells, 779 P.2d 1083 (Or. Ct. App. 1988).

Reviews of Financial Statements: Another attest service performed by CPAs is the review service. Its execution is guided by the Accounting and Review Services pronouncements issued by the AICPA. See 2 AICPA POFESSIONAL STANDARDS, Accounting and Review Services, all sections at 3311-4107 (Am. Inst. of Certified Pub. Accountants (CCH) 1990). The outcome of the review service is negative assurance about the fairness of the financial statements of the entity being reviewed. See id. AR Section 100.35, at 3320 (". .. I am (we are) not aware of any modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.").

In conjunction with a review service, the CPA performs some limited procedures including detailed management inquiries and analytical review procedures. Overall, the inquiries are intended to determine that the financial statements are materially correct and have been prepared in accordance with GAAP. The analytical review procedures are intended to determine that the financial statements do not show any unusual relationships and trends.

Reviews of Interim Financial Statements: As part of their responsibilities to large clients who usually have reporting requirements with the SEC, auditors typically perform reviews of their clients" interim financial statements. These statements are filed with the SEC as part of the required 10Q filing. Although the audit procedures are very similar to those of annual reviews, the professional standards that guide the performance of interim reviews are different. 1 AICPA PROFESSIONAL STANDARDS, U.S. Auditing Standards Section 722 (Am. Inst. Certified Pub. Accountants (CCH) 1990).

In Union Bank v. Ernst & Whinney, 278 Cal. Rptr. 490 (Cal. Ct. App. 1991) (the "Z Best" case), the court held that a review report of this type could not be the basis for a negligence or fraud claim against an independent accountant. The court noted:

Our research has disclosed no case in the more than 50 years since enactment of the first securities laws where a creditor was permitted to recover against an accountant based upon a review report contained in a public offering prospectus. Federal courts have routinely held that review reports included in a prospectus cannot form the basis of claims by investors even under common law fraud or common law accountant negligence theories.

Id. at 497 (emphasis in the original). The dissent argued that RESTATEMENT (SECOND)

OF TORTS Section 552 would impose liability for negligent representation on an accountant who has foreseen a relying third party, even in the case of an unaudited review report. Id. at 502-04 (Johnson, J., dissenting).

Special-Purpose Reports: CPAs also perform other attest engagements. CPAs have been requested by various parties to provide special reports such as Reports on Specified Elements, Accounts or Items, or Reports on Compliance with Aspects of Contractual Agreements. These engagements have limited reporting objectives; however, the CPA is still attesting to the fairness of some aspect of the financial statements or the related accounts. There is a specific SAS entitled "Special Reports" which outlines guidelines for these engagements. See 1 AICPA PROFESSIONAL STANDARDS. U.S. Auditing Standards, AU Section 623, at 1077-98 (Am. Inst. of Certified Pub. Accountants (CCH) 1990).

Prospective Financial Statements: The final attest service relates to prospective financial statements such as financial forecasts and projections. Forecasts predict an entity's future expected financial statements to the best of the client's management's knowledge. Projections are distinguished from financial forecasts in that they represent the future expected financial statements of the client company given one or more hypothetical assumptions.

Certain attestation standards have been drafted in order to provide guidance in this area. The CPA has some exposure when an examination report is issued in conjunction with a financial forecast or projection. In the examination report, the CPA offers some assurance to the readers that the prospective financial statements are prepared in conformity with AICPA presentation guidelines and that the underlying assumptions provide a reasonable basis for the prospective financial position included in the financial forecast or projection. See 1 AICPA PROFESSIONAL STANDARDS, Attestation Standards, AT Section 200.28, at 2548 (Am. Inst. of Certified Pub. Accountants (CCH) 1990).

(n58) See supra note 57 discussing the sources of authority for American accounting principles and auditing standards, FASB and the AICPA.

(n59) Even if an auditor permits its client to include material misstatements in unqualified audited financial statements, losses to creditors, guarantors, and investors do not necessarily follow. Despite its publishing errors and irregularities in its statements, the company may continue to to meet its financial obligations, and investors may be able to sell their shares with gains. In recent years, however, the margin for error seems to be less. Conditions of high debt, fierce global competition, and volatile commodities markets seem to be leading large corporations to insolvency more often than once was the case.

(n60) AICPA PROFESSIONAL STANDARDS, Code of Professional Ethics ET Section 51.04 (Am. Inst. of Certified Pub. Accountants (CCH) 1984).

(n61) United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984).

(n62) 223 Cal. Rptr. 218, 224-25 (Cal. Ct. App. 1986) overruled by Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992). See supra note 22.

(n63) 223 Cal. Rptr. at 225-27.

(n64) PREVITS & MERINO, supra note 30, at 316. The use of footnotes to the statements would be insufficient to avoid this presumption.

(n65) Id. at 316-17.

(n66) Id. at 317.

(n67) See Accounting and Auditing Practices and Procedures: Hearings before Subcomm. on Reports, Accounting, and Management of the Senate Comm. on Governmental Affairs, 95th Cong., 1st Sess. (1977); Reform and Self-Regulation Efforts of the Accounting Profession: Hearings before Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Com., 95th Cong., 2d Sess. (1978).

(n68) PREVITS & MERINO, supra note 30, at 318.

(n69) See id. ("This alleged lack of independence, [the report] contended, raises the prospect of a breakdown in confidence in the auditors' attest function.").

(n70) See, e.g., Robert Chatov, The Possible New Shape of Accounting in the United States, 4 J. ACCT. & PUB. POL'Y 161, 168-69 (1985). The SEC requires accounting firms to disclose non-audit services performed by auditors in excess of three percent of audit fees. PREVITS AND MERINO, supra note 30, at 318.

(n71) Accounting firms have long provided assistance to their clients with respect to problems clearly associated with the internal accounting functions. These consultations have gradually expanded to include a broad range of management activities such as marketing, production, and risk management that have but a tenuous relationship to accounting. Robert Chatov reports on a Wall Street Journal ad in which a C.P.A. firm classified its services "into two groups: the traditional ones like accounting and auditing, tax planning and management consulting; and the specialized ones that include financial institutions, health care, and emerging business." Chatov, supra note 70, at 163 (emphasis added; Chatov appears to be exercised over the classification of management consulting as a "traditional" service).

(n72) PREVITS & MERINO, supra note 30, at 318.

(n73) Id.

(n74) See Kevin G. Salwen, Ernst & Young Faces Lawsuit from the SEC, WALL ST. J., June 14, 1991, at A3.

(n75) See Lee Berton, Accounting Institute Proposes Total Ban on Loans from Audit Clients, WALL ST. J., June 13, 1991, at A2.

(n76) Chatov, supra note 70, at 162.

(n77) SEC and Corporate Audits: Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Com., 99th Cong., 1st Sess. (1985) [hereinafter Dingell Comm. Hearings]. The Committee examined two business failures in depth, that of E.S.M. Government Securities and the Beverly Hills Savings and Loan Association.

(n78) E.g., id., Part 1, at 762-922 (testimony of Phillip B. Chenok, President, AICPA); (testimony of Arthur M. Wood, Chairman, AICPA POB and A. A. Sommer, Jr., member, AICPA); Id., Part 5, at 108-254 (testimony of Michael Cook, Chairman Elect, AICPA, Philip B. Chenok, President, AICPA, and George D. Anderson, founding partner, Anderson, Zurmuchlen and Co., and Chairman, Special Committee on Standards of Professional Conduct for Certified Public Accountants, AICPA).

(n79) E.g., id., Part 1, at 402-43 (testimony of Frederick D. Wolf, Director, Accounting and Financial Management Division, GAO); 451-693, 1011-1234 (testimony of John S. Shad, Chairman, SEC and Clarence A. Sampson, Chief Accountant, SEC); id., Part 2 at 287-303 (testimony of Daniel L. Goelzer, General Counsel, SEC); id., Part 3, at 447-581 (testimony of James M. Cirona, President, Federal Home Loan Bank of San Francisco and Principal Supervisory Agent, 11th District, Federal Home Loan Bank Board [FHLBB], Richard H. Holt, former Senior Examiner, 11th District, FHLBB, Roy A. Bonner, former Field Manager, 11th District, FHLBB, and Glen M. Sanders, former Chief Appraiser and Loan Underwriter, 11th District, FHLBB). Id., Part 4, at 142-69 (testimony of Ralph W. Christy, Deputy General Counsel, Operations and Administration, FHLBB). Id., Part 5, at 3-43 (testimony of Frederick D. Wolf); 43-69 (testimony of Peter O. Stearns, former Director, FSLIC); 70-97 (testimony of William M. Isaac, former Chairman, FDIC); 531-64 (testimony of William L. Seidman, Chairman, FDIC). Id., Part 6, at 3-32 (testimony of Charles A. Bowsher, Comptroller General).

(n80) E.g., id., Part 2, at 198-286 (testimony of Robert Kleckner, Executive Partner, Alexander Grant and Co.); 317-401 (testimony of J. Michael Cook, Managing Partner and Ronald A. Jones, Partner, Deloitte Haskins and Sells); 402-89 (testimony of Lee B. Brown, Partner, Arthur Andersen and Co.); id., Part 3, at 3-113 (testimony of W. Bowan Cutter, Consulting Partner, Harold S. Schultz, Audit Partner, and Gary Bengtson, Audit Partner, Coopers & Lybrand); id., Part 6, at 254-84 (testimony of Joseph E. Connor, Chairman, Price Waterhouse and Co.).

(n81) Id., Part 1, at 5-176 (testimony of Robert Chatov, Associate Professor, Managerial Economics and Policy, School of Management, State University of New York at Buffalo and Abraham J. Briloff, Accountancy Professor, Bernard M. Baruch College, City University of New York).

(n82) See id., Part 6. The Financial Fraud Detection and Disclosure Act of 1986, H.R. 4886, 99th Cong., 2d Sess. 1986, would have "amend(ed) the Securities Act of 1934 to require audits performed under the Federal securities laws to include reasonable procedures for financial fraud detection, and to require that auditors report fraudulent activities to appropriate enforcement and regulatory authorities...." 132 CONG. REC. H3266 (daily ed. May 24, 1986) (Public Bills and Resolutions).

(n83) Dingell Comm. Hearings, supra note 77, at 108-254, 288-446 (testimony from representatives of the accounting profession and officials of the SEC).

(n84) The advent of the FASB roughly corresponded to the corporate foreign-bribery and slush-fund atrocities of the early 1970s. The argument was made during the Metcalf hearings that reforms had been undertaken by the profession, which, along with the 1977 Foreign Corrupt Practices Act, would minimize chances of a recurrence. Chatov, supra note 70, at 162.

(n85) PREVITS & MERINO, supra note 30, at 323.

(n86) Id. at 324. See also Peter Truell & Lee Berton, Price Waterhouse Affiliate Omitted Concerns Over Lending in BCCI Audit, WALL ST. J., June 20, 1991, at A3 (U.S. Price Waterhouse firm takes the position that the British affiliate is legally independent entity so that its liability exposure is separate from its own).

(n87) Chatov, supra note 70, at 163.

(n88) Id. at 172.

(n89) Id. at 173.

(n90) See PREVITS & MERINO, supra note 30, at 319. With respect to shortening the learning curve for new auditors, see infra note 402 and accompanying text.

(n91) See infra notes 395-402 and accompanying text.

(n92) See infra notes 398, 399, 402 and accompanying text.

(n93) Robert A. Lyon, Auditing Standards in the United Kingdom, in COMPARATIVE INTERNATIONAL AUDITING STANDARDS 68 (Belverd E. Needles, Jr. ed. 1985).

(n94) Id.

(n95) Id.

(n96) Id.

(n97) AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, THE ACCOUNTING PROFESSION IN THE UNITED KINGDOM 8-9 (1987).

(n98) Lyon, supra note 93, at 72.

(n99) DEP'T TRADE & INDUS., PROFESSIONAL LIABILITY: REPORT OF THE STUDY TEAMS 23 (Andrew Likierman, Chairman, 1989) [hereinafter LIKIERMAN REPORT).

In May 1988 the Secretary of State for Trade and Industry announced the appointment of three fact-finding teams: "in the light of current concern about the cost and availability of professional indemnity insurance and the extent of civil liability for negligence to look into the problems of three related professions -- auditors, those involved in the construction industry and surveyors...."

Id. at 5.

(n100) Id. at 23.

(n101) In discussing the auditor's "basic duty of care," the Likierman Report, supra note 99, stated:

It is claimed that no auditor who sets out on an audit can be certain how, if asked, the court would interpret the implied terms [of an audit engagement contract] in relation to that particular audit. In practice such an interpretation, if it becomes necessary, will be determined with hindsight by the court, which will hear evidence as to the standards which other accountants would have expected themselves to have applied to the particular circumstances at the particular time. Id. at 22. The Likierman Report authors concede that, while written professional standards do provide "a measure of certainty, compared with the other professions," and that these standards "are very strong evidence as to the proper standard," id., "the court may still take the view that this was not good enough in the particular circumstance. It has, further been represented to [them] that the court tends to lean in favour of the plaintiff in eases involving claims against auditors." Id. at 23.

(n102) See Marianne M. Jennings et al., The Auditor's Dilemma: The Incongrous Judicial Notions of the Auditing Profession and Actual Auditor Practice, 29 AM. Bus. L.J. 99, 115 (1991):

The other pre-case [judicial] belief with a high number of responses [to an attitudinal survey of judges] was that the auditor has the responsibility to search actively for fraud. The position of the auditing profession is that fraud cannot always be detected because auditors must rely on statistical sampling techniques. Although proper auditing techniques should bring to light certain types of frauds, auditors contend the client's employees or even management could veil the fraud and leave the auditor with no clues. However, the judicial attitudes suggest that, in spite of limited procedures and possible cover-ups, the auditor has a high degree of responsibility for detecting fraud.

(n103) Lyon, supra note 93, at 72.

(n104) Id. at 72-73.

(n105) See LIKIERMAN REPORT, supra note 99, at 23-25. The degree of proximity between auditor and third party necessary to establish liability for negligent misstatement is a question that has been developing in British courts since 1951, and, as in the United States, does not yet appear to have come to rest. A holding from a 1981 case resembled the reasonable foreseeability rule of H. Rosenblum v. Adler, and "[t]his expansion in the range of third parties to whom duties are owed was a cause of considerable concern to accountants," but "there has been a narrowing in the scope of tortious liability for economic loss in the past few years." Id. at 24.

(n106) Nathan Kranowski, Auditing Standards in France, in COMPARATIVE INTERNATIONAL AUDITING STANDARDS 37 (Belverd E. Needles Jr. ed. 1985) [hereinafter Kranowski].

(n107) JEFFREY S. ARPAN & LEE H. RADEBAUGH, INTERNATIONAL ACCOUNTING AND MULTINATIONAL ENTERPRISES 30 (1981).

(n108) Kranowski, supra note 106, at 37.

(n109) Id. at 38; LESLIE G. CAMPBELL, INTERNATIONAL AUDITING 59 (1985).

(n110) Kranowski, supra note 106, at 37.

(n111) Id.

(n112) Id. at 41.

(n113) Id. at 38.

(n114) Id. at 40.

(n115) CAMPBELL, supra note 109, at 60.

(n116) Kranowski, supra note 106, at 40.

(n117) Id.

(n118) Id. at 41.

(n119) CAMPBELL, supra note 108, at 60.

(n120) Dingell Comm. Hearings, supra note 77, Part 6 at 18-19.

(n121) See supra note 82.

(n22) Tadakazu Nakase, Auditing Standards in Japan, in COMPARATIVE INTERNATIONAL AUDITING STANDARDS 106 (Belverd E. Needles Jr. 1985) [hereinafter Nakase].

(n123) Id. at 107.

(n124) Id. at 106.

(n125) CAMPBELL, supra note 109, at 86

(n126) Nakase, supra note 122, at 109;

(n127) Id. at 110, 113.

(n128) Auditors are responsible for detecting illegal acts insofar as they materially affect the fairness of the financial statements. Illegal acts are considered to be any violations of the law. 1 AICPA PROFESSIONAL STANDARDS, U.S. Auditing Standards section 317.05 and 316.05 (Am. Inst. of Certified Pub. Accountants (CCH) 1990).

(n129) Nakese, supra note 122, at 113.

(n130) Id. at 114.

(n131) In the United States, it is commonplace for CPAs performing audit services to offer additional services such as tax and management consulting to their audit clients. However, an auditor is not allowed to function "as a promoter, underwriter or voting trustee, as a director or officer, or in any capacity equivalent to that of a member of management or of an employee." 2 AICPA PROFESSIONAL STANDARDS, Code of Professional Conduct ET section 101.02 101-181 (Am. Inst. of Certified Pub. Accountants (CCH) 1990). For criticism of the American practice of allowing auditors to offer non-audit services to audit clients, see supra notes 72-91 and accompanying text.

(n132) CAMPBELL, supra note 109, at 51.

(n133) W. Morley Lemon, Auditing Standards in Canada, in COMPARATIVE INTERNATIONAL AUDITING STANDARDS 124 (Belverd E. Needles Jr. ed. 1985) [hereinafter Lemon].

(n134) CAMPBELL, supra note 109, at 9.

(n135) See AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, THE ACCOUNTING PROFESSION IN CANADA 9 (2d ed. 1990) (discussing CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS, CICA HANDBOOK section 5000).

(n136) Lemon, supra note 133, at 125.

(n137) Id. at 127-28.

(n138) Id. at 128.

(n139) Id.

(n.140) Id.

(n141) Id.

(n142) Id. at 129.

(n143) See Id. at 127.

(n144) ARPAN & RADEBAUGH, supra note 107, at 30-31.

(n145) 35 N.Y. 210 (1866).

(n146) My opinion therefore is, that this action cannot be sustained, for the reason that the damages incurred are not the immediate but the remote result of the negligence of the defendants...

To sustain such a claim as the present, and to follow the same to its legitimate consequences, would subject to a liability against which no prudence could guard, and to meet which no private fortune would be adequate.

Id. at 213.

(n147) See PROSSER & KEETON ON TORTS, supra note 4, at 25. "This [reluctance of the courts to saddle an entire industry with the entire harm it may cause] is particularly true where the liability may extend to an unlimited number of unknown persons, and is incapable of being estimated or insured against in advance." Id. citing Moch Co. v. Rensselaer Water Co., 159 N.E. 896 (N.Y. 1928); Palsgraf v. Long Island R.R., 162 N.E. 99 (N.Y. 1928); and Ryan, 35 N.Y. 210 (1866). Certainly, Ultramares v. Touche belongs in this distinguished company. See quotation supra note 11.

(n148) See William Prosser, Comparative Negligence, 41 CAT. L. REV. 1, 1-4 (1953) [hereinafter Comparative Negligence]. As early as 1953 William Prosser noted that the United States is virtually the last stronghold of contributory negligence. The last vestiges of the complete defense disappeared long since from continental Europe, which divides the damages, Great Britain, all of the Canadian provinces, New Zealand ... have come to the same result so that little of the British Empire is left with the common law rule. Id. at 2.

(n149) See infra notes 193-94 and accompanying text.

(n150) See Comparative Negligence, supra note 148, at 9. "Obviously any estimate that 40 percent of the total fault rests with the pedestrian who walks out in the street in the path of an automobile, and 60 percent with the driver who is not looking and runs him down represents nothing resembling accuracy based on demonstrable fact. The estimate might quite as well be anywhere between 25-75 and 75-25." Id.

(n151) See id. Dean Prosser observes, "This uneasy distrust of the twelve men and now women, in the box has bulked large in American negligence law; and it is significant that damage apportionment developed first, and succeeded best, in [non-American] courts where there is no jury to contend with."

(n152) See id. at 4 ("No one ever has succeeded in justifying that as a policy [i.e., visiting the entire loss on one of two parties that caused it], and no one ever will.").

(n153) Id. at 5-9.

(n154) "Indeed, since the apportionment of fault and damages is by nature a factual matter, virtually every ease must be given to the jury...." PROSSER & KEETON, supra note 4, at 470. "The first state to adopt a general comparative negligence act was Mississippi, which in 1910 enacted a statute applicable to all actions for personal injuries, and expanded it in 1920 to include damages to property." Id. at 471.

(n155) "Although by the 1960s only seven states had replaced contributory negligence with comparative fault ... the early 1970s and 1980s witnessed a surge of legislative and judicial action accomplishing the switch. As of 1982, some 40 states had adopted some general form of comparative negligence." Id.

(n156) This issue is whether to adopt the "pure" or "modified" forms of comparative negligence. See id. at 471-74. There are also the issues of whether negligence can be compared with intentional torts, see infra notes 233-58 and accompanying text, whether negligent misrepresentation is subject to comparative negligence treatment, see infra notes 259-71 and accompanying text, whether the plaintiffs negligence can be compared with the defendant's strict liability, see PROSSER & KEETON, supra note 4, at 478, and whether a jury determination of equal fault should permit recovery under modified comparative fault, see id., at 473.

(n157) One problem is whether in a modified system the trier of fact may compare the plaintiff's negligence with that of each defendant or only with the aggregate of all the defendants' fault (the unit rule). In PROSSER & KEETON, supra note 4, at 473, the authors point out that individual apportionment creates an incentive for the defendants to artificially increase the number of nominal defendants and discourages plaintiffs from joining defendants. This is so because, if every defendant is deemed to be less at fault than the plaintiff, the plaintiff recovers nothing even though his fault may be less than 50% overall.

Another problem is whether to consider the fault of immune or absent tortfeasors. Jurisdictions handle these eases differently. Some ignore the negligence of the phantom tortfeasors, thus allowing the trier of fact to allocate 100% of the fault to the plaintiff and the joined defendants. Others consider the fault of "phantom" defendants thus reducing the judgments against the joined defendants. Under a joint and several rule the plaintiff would still have a chance for full recovery, but under a several liability rule his chances would be less.

Under a joint and several rule, a defendant who has paid more than her equitable share, whether pro rata under an equality rule, or proportionate to fault under comparative fault principles, can generally seek contribution from joint tortfeasors for the excess she paid the plaintiff. (The equitable share of each defendant could be less or more depending on whether the negligence of absent or immune tortfeasors were considered.)

Defendants who have been released by the plaintiff in good faith and certain kinds of immune defendants such as negligent employers covered by workers' compensation's exclusivity statutes add additional complexity and variability to the contribution equation. In addition, certain kinds of defendants who are only vicariously or derivatively liable may be able to maintain common law indemnity actions against others who are under an obligation to assume the responsibility. See PROSSER & KEETON, supra note 4, at 475-77.

Finally, there is the problem of the insolvent tortfeasor whether joined or not. That ease provides the principal subject matter of this article. The authors argue for a rule that considers and compares the fault of the insolvent tortfeasor, whether it is negligence or intentional conduct, and subjects it and the fault of others to a several liability rule.

(n158) See generally, Ray J. Aiken, Proportioning Comparative Negligence--Problems of Theory and Special Verdict Formulation, 53 MARQ. L. REV. 293 (1970); Damon Ball, A Reexamination of Joint and Several Liability Under a Comparative Negligence System, 18 ST. MARY'S L.J. 891 (1989); Kim B. Childs, The Apportionment of Tort Responsibility, 14 COLO. LAW. 741 (May 1985); Richard A. Epstein, Two Fallacies in the Law of Joint Torts, 73 GEO. L.J. 1377 (1985); James Granelli, The Attack on Joint and Several Liability, 71 A.B.A. J. 61 (July 1985); David Kaye & Mikel Aickin, A Comment on Causal Apportionment, 13 J. LEGAL STUD. 191 (1984); Lewis A. Kornhauser & Richard L. Reveez, Sharing Damages Among Multiple Tortfeasors, 98 YALE L.J. 831 (1989) [hereinafter Sharing Damages]; Lewis A. Kornhauser & Richard L. Revesz, Apportioning Damages Among Potentially Insolvent Actors; 19 J. LEGAL STUD. 617 (1990); William M. Landes & Richard A. Posner, Joint and Multiple Tortfeasors: An Economic Analysis, 9 J. LEGAL STUD. 517 (1980); Robert A. Leflar, Contribution and Indemnity Between Tortfeasors, U. PA. L. REV. 130 (1932); William J. McNichols, Judicial Elimination of Joint and Several Liability Because of Comparative Negligence -- A Puzzling Choice, 32 OKLA. L. REV. 1 (1979); Marie D. Mendelson, Tort Reform: Ensuring the Most Equitable Results for Plaintiffs and Defendants?, 31 ARIZ. L. REV. 171 (1989); Richard N. Pearson, Apportionment of Losses Under Comparative Fault Laws -- An Analysis of the Alternatives, 40 LA. L. REV. 343 (1980); Lisa M. Pennock, The Effect of Comparative Fault on Personal Injury Awards in Malpractice Lawsuits Involving Multiple Tortfeasors, 6 J. LEGAL MED. 223 (1985); Richard J. Pierce, Jr., Encouraging Safety: The Limits of Tort Law and Government Regulation, 33 VAND. L. REV. 1281 (1980); Larry Pressler & Kevin V. Schieffer, Joint and Several Liability: A Case for Reform, 64 DEN. U. L. REV. 651 (1988); William Prosser, Comparative Negligence, 41 CAL. L. REV. 1 (1953); Mario J. Rizzo & Frank S. Arnold, Causal Apportionment: Reply to the Critics, 15 J. LEGAL STUD. 219 (1986); Mario J. Rizzo & Frank S. Arnold, Causal Apportionment in the Law of Torts: An Economic Theory, 80 COLUM. L. REV. 1399 (1980); Florrie Roberts, The Relatively Insolvent Joint Tortfeasor and the Good Faith Settlement, 20 LOY. L.A.L. REV. 247 (1987); James J. Scheske, The Reform of Joint and Several Liability Theory: A Survey of State Approaches, 54 J. AIR L. & COM. 627 (1988); Victor E. Schwartz, Comparative Negligence in Indiana: A Unique Statute That Will Reshape the Law, 17 IND. L. REV. 957 (1984); David R. Smith & John W.

Wade, Fairness: A Comparative Analysis of the Indiana and Uniform Comparative Fault Acts, 17 IND. L. REV. 969 (1984); Mike Steenson, Recent Legislative Responses to the Rule of Joint and Several Liability, 23 TORT & INS. L.J. 482 (1988); Aaron D. Twerski, The Many Faces of Misuse: An Inquiry Into the Emerging Doctrine of Comparative Causation, 29 MERCER L. REV. 403 (1978); John W. Wade, Should Joint and Several Liability of Multiple Tortfeasors be Abolished?, 10 AM. J. TRIAL ADVOC. 193 (1986); Eileen M. Walsh & Eugene G. Doherty, Section 2-1117: Several Liability's Effect on Settlement and Contribution, 79 ILL. B.J. 122 (1991); Richard W. Wright, Allocating Liability Among Multiple Responsible Causes: A Principled Defense of Joint and Several Liability for Actual Harm and Risk Exposure, 21 U.C. DAVIS L. REV. 1141 (1988); Brad C. Betebenner, Comment, The Liability Reform Act: An Approach To Equitable Application, 13 J. CONTEMP. L. 89 (1987); John Conger, Note, If They're Partly to Blame, Why Should I Get Stuck With the Bill?, 3 COOLEY L. REV. 343 (1985); Kathleen Coughenour, Comment, The Right to Recover Damages: Tort Reform and the Arizona Constitution, 20 ARIZ. ST. L.J. 227 (1988); Armando Garcia-Mendoza, Comment, Tort Law: Joint and Several Liability Under Comparative Negligence--Forcing Old Doctrines on New Concepts, 40 U. FLA. L. REV. 469 (1988); Brian E. Koeberle, Comment, Recent Developments--Tort Law--Uniform Contribution Among Tortfeasors Act--Comparative Negligence Act, 27 DUQUESNE L. REV. 163 (1988); Stephanie A. Kraft, Note, Modification of the Doctrine of Joint and Several Liability: Who Bears the Risk?, 11 NOVA L. REV. 165 (1986); Mary A. Laudick, Comment, Status and Trends in State Product Liability Law: Joint and Several Liability, 14 J. LEGIS. 242 (1987); R. Michael Lindsey, Comment, Compensation, Fairness, and the Costs of Accidents --Should Pennsylvania's Legislature Modify or Abrogate the Rule of Joint and Several Liability Among Concurrently Negligent Tortfeasors?, 91 DICK. L. REV. 947 (1987); Nancy L. Manzer. Note, 1986 Tort Reform Legislation: A Systematic Evaluation of Caps on Damages and Limitations on Joint and Several Liability, 73 CORNELL L. REV. 628 (1988); Edward J. McBride, Jr., Note, Fair Enough' Modifying the Rule of Joint and Several Liability in New Jersey, 20 RUTGERS L.J. 175 (1988); Comment, The Case of the Disappearing Defendant: An Economic Analysis, 132 U. PA. L. REV. 145 (1983).

(n159) See, e.g., International Mortgage Co. v. John P. Butler Accountancy Corp., 223 Cal. Rptr. 218 (Cal. Ct. App. 1986); overruled by Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992). See supra note 22. Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408 (Text Ct. App. 1986).

(n160) 461 A.2d 138 (N.J. 1983). See supra notes 10-14 and accompanying text.

(n161) Third-party practice allowing defendants to join other defendants in a single action is a relatively modern procedure that facilitates the administration of comparative fault systems. See Wade, supra note 158, at 193. There is a practical downside, however, in joining one's clients or customers as joint defendants in a lawsuit. It is a tactic that is sure to make it more difficult for the auditor to attract new clients. A several only liability rule would motivate plaintiffs more strongly to sue all potential defendants than would a joint liability rule, thus ameliorating that problem.

(n162) If the relying third party is found to be negligent, the judgment against the auditor will be reduced. However, the question remains how the apportioned judgment against the insolvent client should be assigned among the remaining solvent, culpable tortfeasors and the negligent plaintiff. One view is that the tortfeasors should absorb the entire amount under joint and several principles, the other is that "unmet responsibilities should be reallocated among all parties at fault, including a negligent plaintiff, in accordance with the established percentages of fault." Wade, supra note 158, at 211. Under several liability, of course, the plaintiff, negligent or not, absorbs the entire loss of insolvent defendants.

(n163) In McLean v. Alexander, 599 F.2d 1190 (3d Cir. 1979), a federal district court's application of relative fault principles to a case in which an auditor was one of several defendants was overruled on appeal. The appellate court found there was no common law fraud on the part of the auditor and, therefore, under Ultramares, there was no liability. In a more recent Texas ease, a comparative fault verdict was rendered against several defendants including a negligent auditor. The jury found $20 million in compensatory damages and assessed $530 million in punitives, including $200 million against the auditor. See Harlan, supra note 25. The parties settled for an undisclosed amount several days after the verdict was rendered. See Andrew Pollock, Big Defendants Settle in MiniScribe Lawsuit, N.Y. TIMES, Feb. 19, 1992, at D4. For another perspective on this ease, see infra note 330 and accompanying text.

There are a few auditor malpractice eases in which the auditor's negligence has been compared with that of the plaintiff client. See, e.g., Deveo Premium Finance Co. v. North River Ins. Co., 450 So. 2d 1216 (Fla. Dist. Ct. App. 1984) (client 80% at fault; auditor 20%); Capital Mortgage Corp. v. Coopers & Lybrand, 369 N.W.2d 922 (Mich. Ct. App. 1985) (client 68.3% at fault; auditor 31.7%); Halla Nursery, Inc. v. Baumann-Furrie & Co., 454 N.W.2d 905 (Minn. 1990) (client 80% at fault; auditor 20%).

(n164) See infra notes 165-96 and accompanying text.

(n165) 208 N.Y.S. 259, 268-69 (1925), aff'd 152 N.E. 431 (N.Y. 1926) (mem.).

(n166) The majority cites cases and other authorities that meld issues of contributory negligence and proximate cause. Arguably, the criminality of the defaulting employee can be said to be a superseding cause of the plaintiff's loss. 208 N.Y.S. at 268. And if the gravamen of the action is deemed to sound in contract despite its trappings of tort, "the defaulting party [in this case the auditor] is liable only for the direct consequence of the breach ...." Id. at 268 (citing City of East Grand Forks v. Steele, 141 N.W. 181, 182 (45 L.R.A. [N.S.] 205).

(n167) See David L. Menzel, The Defense of Contributory Negligence in Accountant's Malpractice Actions, 13 SETON HALL L. REV. 292, 295-99 (1983) (discussing contemporaneous critiques of the Craig majority opinion on both doctrinal and policy grounds).

(n168) "They were the very thing the contract was made to detect and prevent." Comment, The Legal Responsibility of Public Accountants, 35 YALE L.J. 76, 83 (1925).

(n169) 208 N.Y.S. at 269-70.

(n170) See Shapiro v. Glekel, 380 F. Supp. 1053 (S.D.N.Y. 197A] (New York law)i (n170) See Shapiro v. Glekel, 380 F. Supp. 1053 (S.D.N.Y. 1974) (New York law); National Security Corp. v. Lybrand, 9 N.Y.S.2d 554 (N.Y. App. Div. 1939).

(n171) See, e.g., Fullmer v. Wohlfeiler & Beck, 905 F.2d 1394 (10th Cir. 1990) (Utah law); Lincoln Grain Inc. v. Coopers & Lybrand, 345 N.W.2d 300 (Neb. 1984).

(n172) Menzel, supra note 167, at 296 (citing comment, supra note 168 at 83).

(n173) N.Y.S.2d at 563 ("We are not prepared to admit that accountants are immune from the consequences of their negligence because those who employ them have conducted their businesses negligently.").

(n174) Id.

(n175) If the client were negligent "in connection with the transfer of funds which occurred at about the time of each audit and that such negligence contributed to the [auditor's] false reports, only then would it be sufficient to raise a defense to the action." 9 N.Y.S.2d at 563.

(n176) See Capital Mortgage Corp. v. Coopers & Lybrand, 369 N.W.2d 922, 925 (Mich. Ct. App. 1985) ("We find the application of comparative negligence to be proper as neither party is absolved of fault due to the other's negligence.").

(n177) See Jennings et al., supra note 102.

(n178) 380 F. Supp. 1053 (S.D.N.Y. 1974) (New York law).

(n179) Id. at 1058 (relying heavily on Carl S. Hawkins, Professional Negligence Liability of Public Accountants, 12 VAND. L. REV. 797, 809-11 (1959)).

(n180) 486 S.W.2d 914 (Teen. Ct. App. 1972).

(n181) Id. at 920 (quoting Craig, 208 N.Y.S. at 268).

(n182) Menzel, supra note 167, at 305 n.94.

(n183) RESTATEMENT (SECOND) OF TORTS Section 552A (1977) provides, "The recipient of a negligent misrepresentation is barred from recovery for pecuniary loss suffered in reliance upon it if he is negligent in so relying."

(n184) Menzel, supra note 167, at 305.

(n185) That Restatement Section 552A is silent with respect to the application of general principles of contributory negligence to cases of auditor liability hardly precludes those principles (found elsewhere in the Restatement) from having applicability to the special case.

(n186) To date, actions by the FDIC against auditors of insolvent savings and loans have not been third party suits. Rather, the government sues "in its capacity as regulator of the thrift industry" or in its capacity as "appointed conservator or receiver." Jeffrey N. Leibell, Note, Accountants' Liability in the Savings and Loan Crisis: An Argument in Favor of Affirmative Defenses, 1991 COLUM. Bus. L. REV. 71, 74. Recently, the latter strategy was struck a blow when a federal district court granted an auditor's motion for summary judgment on the theory that the single owner management of Western Savings and Loan had no cause of action against the thrift's auditor, thus, neither did the FDIC as receiver. The reason why the court found that management's suit would have failed was that management was already aware of everything the auditor could have told it. See Sherry R. Sontag, Audit Ruling May Portend Other Losses, NAT'L L.J., October 28, 1991, at 3 (discussing FDIC v. Ernst & Young, No. 3-90-0490 (N.D. Tex., Sept. 29, 1991)). With respect to its role as regulator, the FDIC "must prove defendants were unjustly enriched or recklessly disregarded laws or regulations--much tougher to prove than negligence, the standard for receiver suits." Id. But see Wade Lambert, FDIC is Cleared to Sue Law Firm For Negligence in S&L Fraud Case, WALL ST. J., July 1, 1992, at B4 (describing an even more recent decision against law firm in which court ruled that the "FDIC can't be resticted in pursuing negligence claims just because the former officers of the thrift were the people directly accused of the wrongdoing.").

If it were not for state law privily barriers, it would appear viable for the FDIC to bring suit against a thrift's auditor as a third party guarantor (i.e., guaranteeing the obligations of the thrift to its depositors to pay on demand with interest). There is, of course, a standing question, but it should be apparent that governmental loss, due at least partially to auditor negligence, would be both substantial and reasonably direct. Whether the auditors should be permitted in such an instance to raise the contributory negligence of the FDIC in its role as failed regulator of the failed thrift, is a question discussed in Leibell, supra, at 77-90.

(n187) This result would obtain if a lax management were to recover all its losses to third parties by successfully suing its negligent auditors for malpractice in actions if the plaintiff's laxness is precluded as a defense.

(n188) 345 N.W.2d 300 (Neb. 1984).

(n189) Id. at 306-07.

(n190) 450 So. 2d 1216 (Fla. Dist. Ct. App. 1984).

(n191) Id. at 1220. See also Capital Mortgage Corp. v. Coopers & Lybrand, 309 N.W.2d 922 (Mich. Ct. App. 1985) "With comparative negligence the result is not so harsh and the policy considerations that accountants should not be allowed to avoid all liability due to some negligence on the part of the client are not present." Id. at 925.

(n192) Id.

(n193) In the late 1970s, in several product liability eases, courts ostensibly apportioned damages using a theory of comparative causation, the most noteworthy being General Motors Corp. v.

Hopkins, 548 S.W.2d 344 (Text 1977). The effect was to reduce the plaintiff's judgment rendered under strict liability in proportion to the causal contribution of the plaintiff's "unforseeable misuse." The goal was to circumvent the "apples and oranges" problem of comparing fault with strict liability. The concept is discussed in Aaron D. Twerski, The Many Faces of Misuse: An Inquiry into the Emerging Doctrine of Comparative Causation, 29 MERCER L. REV. 403 (1978).

Other writers have sought to develop a general theory of casual apportionment for tort eases. See Mario J. Rizzo & Frank S. Arnold, Casual Apportionment in the Law of Torts: An Economic Theory, 80 COLUM. L. REV. 1398 (1980). These authors employ the concept of "probalistic marginal product" (PMP) to develop a "technology" that assigns damage shares in simultaneous cause cases "by measuring the differential degree of risk to which each cause exposes the plaintiff." Id. at 1408. The authors found their inspiration for developing this method in Richard A. Epstein, A Theory of Strict Liability, 2 J. LEGAL STUD. 151 (1973), in which Professor Epstein calls for the return to a tort system based solely on causation; if A causes harm to B, A should compensate B without inquiry into questions of fault. Although Rizzo and Arnold buy into the simpler rules of Epstein's strict liability world, they claim their technology can also be used to apportion damages among tortfeasors whose conduct has been found to be negligent.

Rizzo and Arnold's technology was criticized in David Kaye & Mikel Aickin, A Comment on Causal Apportionment, 13 J. LEGAL STUD. 191 (1984), which was later followed by a vigorous defense in Mario J. Rizzo & Frank S. Arnold, Causal Apportionment: Reply to the Critics, 15 J. LEGAL STUD. 219 (1986). Without taking sides on the technical aspects of the dispute, we think Kaye and Aicken raise relevant issues when they state, "We think it is fair to ask for some proof that this form of contribution [based on probalistic marginal product] would create the proper incentives for optimal levels of care on the part of each joint tortfeasor." Kaye & Aicken, supra, at 205. They note that Rizzo and Arnold "do not place much weight on efficiency," id., and conclude that, while strict liability may have some claim to greater efficiency over negligence in the absence of administrative and transaction costs, the causal apportionment formula does entail such costs so "that this form of apportionment ... seems difficult to defend on efficiency grounds." Id. With respect to fairness, they state, "it would not follow that apportionment according to some function of the PMPs is the fairest way to impose damages. As far as we can tell, there is no uniquely meaningful or manifestly fairest way to compute the relative contributions of two causes to an indivisible injury." Id. at 206.

(n194) We agree that the probalistic marginal product (PMP), see supra note 193, is an inadequate concept for apportionment because it ignores the egregiousness of the tortfeasor's conduct and the relative stakes the tortfeasors have in the enterprises to which they have contributed their wrongful conduct. On the other hand, we think that the magnitude of each party's contribution to the risk of the indivisible injury is one of the factors to be weighed in reaching a culpability apportionment ratio. If PMP analysis can provide a principled way to derive these magnitudes that is superior to asking the trier of fact in essence to use its intuitive good sense, then we support the concept as being a useful tool for damage apportionment under a negligence regime. We believe, however, that when the weighing of the quantitative production of risk by the various parties is accompanied by weighing egregiousness and the relative stakes of the parties in the enterprise, the intuitive method of calculating comparative contribution is likely to prove the more fair.

(n195) Ideally, all parties should be before the court in a single action. But even if some parties are immune or have settled, the trier of fact should be permitted to consider the conduct of absent parties. We think that, if all the potential parties' conduct and interests are considered, the incentive to demand a jury trial may be reduced, because both plaintiffs and defendants would likely be wary of the uncertainties that the additional complexity would add to the litigation, especially to the apportionment process.

(n196) See, e.g., Robert Mednick, Accountants' Liability: Coping With the Stampede to the Courtroom, J. ACCT., Sept. 1987, at 118, 120.

(n197) 174 N.E. 441 (N.Y. 1931).

(n198) RESTATEMENT (SECOND) OF TORTS 5 552 (1977).

(n199) 461 A.2d 138 (N.J. 1983).

(n200) See Pressler & Schieffer, supra note 158, at 654 nn. 11-12. Senator Pressler and his co-author list a number of senate hearings in which representatives of these interests describe the development of a liability insurance "crisis" affecting their activities. The elimination of joint liability is identified as one of their principal needs to ameliorate the crisis. These authors cite the economic impact of the rule as an important reason to abrogate it. Id. at 684. See also Mednick, supra note 196 and note 403.

(n201) See, e.g., Bartlett v. New Mexico Welding Supply, Inc., 646 P.2d 579, 584-86 (N.M. 1982) (citing Erwin E. Adler, Allocation of Responsibility After American Motorcycle Association v. Superior Court, 6 PEPPERDINE L. REV. 1 (1978)). See also Pressler and Schieffer, supra note 158, at 664-65; John E. Guy, Let's Say Goodbye to Joint Liability, 27 FOR THE DEFENSE 1 (June 1985).

(n202) See Scheske, supra note 158; Steenson, supra note 158. Professor Steenson states, "In 1986 and 1987, half of the states enacted legislation directed toward joint and several liability. The reforms either limit or abolish joint and several liability." Id. at 482. Steenson classifies the various reforms and modifications, noting that the amounts, percentages, and types of damages will often dictate whether the joint and several rule will be applied. In this article, we argue only for abrogation of the rule in financial, negligent misrepresentation cases, and would be satisfied if the rule were retained in cases in which the trier of fact found a high percentage (say, 70% or more) of the total culpability to rest with the negligent auditor. See. e.g., David Hackelman, Bill Seeks to Shield CPA's Liability," CHICAGO DAILY LAW BULL., July 6, 1992, at 1 (reporting that the Illinois General Assembly has approved a bill that "would provide that if a CPA firm was found to have less than one-quarter responsibility for a loss, the firm would be responsible only for its own share of the loss."). See also Brad C. Betebenner, Note, The Liability Reform Act: An Approach to Equitable Application, J. CONTEMP. L. 89 (1987); John Conger, Note, If They're Partly to Blame, Why Should 7 get Stuck With the Bill, 3 COOLEY L. REV. 343

(1985); Kathleen Coughenour, Comment, The Right to Recover Damages: Tort Reform and the Arizona Constitution, 20 ARIZ. ST. L.J. 227 (1987); Armando Garcia-Mendoza, Comment, Tort Law: Joint and Several Liability Under Comparative Negligence - Forcing Old Doctrines on New Concepts, 40 U. FLA. L. REV. 469 (1988); Mary A. Laudick, Note, Status and Trends in State Product Liability Law, 14 J. LEGIS. 242 (1987); R. Michael Lindsey, Note, Compensation, Fairness, and the Costs of Accidents --Should Pennsylvania Modify or Abrogate the Rule of Joint and Several Liability Among Concurrently Negligent Tortfeasors? 91 Dick. L. Rev. (1987); Nancy L. Manzer, Note, 1986 Tort Reform Legislation: A Systematic Evaluation of Caps on Damages and Limitations on Joint and Several Liability, 73 CORNELL L. REV. 628 (1988); Edward J. McBride, Note, Fair Enough? Modifying the Rule of Joint and Several Liability in New Jersey, 20 RUTGERS L.J. 175 (1988).

(n203) See PROSSER & KEETON, supra note 4, at 336 (discussing the purported origin of the rule in the 1799 English ease of Merryweather v. Nixan).

(n204) Id. at 338-40 (discussing the various state statutes "which to a greater or lesser extent permit contribution among tortfeasors").

(n205) See Wade, supra note 158, at 195-99; Wright, supra note 158, at 1185; Garcia-Mendoza, supra note 202, at 471 (discussing Florida's rationale in retaining the joint and several doctrine by relying on its recently enacted Contribution Act).

(n206) See Mednick, supra note 196, at 120-21.

(n207) See American Motorcycle Ass'n v. Superior Court, 578 P.2d 899, 906 (Cal. 1978); Granelli, supra note 158, at 71 ("The rationale is basic fairness. 'Who should suffer, the innocent victim or one of the wrongdoers who can afford to pay?'" quoting James Frayne, executive director of The California Trial Lawyers Association.).

(n208) See Pressler and Schiefer, supra note 158, at 653 n.7 (capsulizing eases in which "deep pocket" defendants are forced to foot the bill for defendants and plaintiffs more at fault in causing the plaintiffs' injuries); Steenson, supra note 158, at 484 (noting that the emergence of comparative fault with its "findings based on percentages of fault also highlight the perceived injustices of the rule of joint and several liability" that were formally "obscured by general verdicts and pro rata liability of joint tortfeasors."); Manzer, supra note 202, at 636 & n.49.

(n209) Bartlett v. New Mexico Welding Supply, Inc., 646 P.2d 579, 585 (N.M. 1982).

(n210) Wade, supra note 158.

(n211) Id. at 194.

(n212) Id.

(n213) Id.

(n214) Id. at 195.

(n215) Id. at 195-96

(n216) Id. at 196.

(n217) Id.

(n218) Id.

(n219) Id. at 197.

(n220) Id.

(n221) Id.

(n222) Id. at 198-99.

(n223) See Steenson, supra note 158, at 485-86, describing several statutes that limit the operation of joint and several liability when the defendant's fault is found to be less than a threshold percentage, or less than the claimant's percentage of fault. For example, a 1986 Alaska statute provided that, when defendants are found less than 50% at fault, their damages are capped at no more than twice their culpability percentages. The Alaska legislature has since moved further: the above statute was replaced with ALASKA REV. STATS. Section 09.17.080 (1987) which provides for several only liability. See also N.J. STAT. ANN. Section 2A:15-5.3(a) (1987) which provides that defendants found 20% or less at fault are responsible only for that percentage attributable to their negligence, and defendants 21 to 59% at fault are subject to joint and several liability only for economic damages. See MeBride, supra note 202, at 175-76. Presumably these limitation provisions imply recognition by state legislatures that feet finders should be permitted to shift liability from insolvent to solvent tortfeasors only when the solvent party is a major contributor to the harm. Presumably, parties who are only peripherally involved in harm-causing enterprises are likely to be deemed only minor contributors to the harm. But see supra note 25.

(n224) See MaePherson v. Buick Motor Co., 111 N.E. 1050 (N.Y. 1916); Henningsen v. Bloomfield Motor Inc. 161 A.2d 69 (N.J. 1960). In both of these major assaults on privity -- the one on the negligence barrier, the other on that imposed by warranty -- the danger to the person was singled out to justify the attacks. This distinction in the nature of the injury at issue was also emphasized in Ultramares. See supra note 13 and accompanying text.

(n225) See Victor P. Goldberg, Accountable Accountants, Is Third Party Liability Necessary', 17 J. LEGAL STUD. 301-02 (describing contractual, insurance-like mechanisms for shifting risk in creditor-investor eases).

(n226) Wade, supra note 158, at 202 ("The conduct of each defendant is then a proximate cause of the collision and therefore of the whole resulting injury to the plaintiff."); Wright, supra note

158, at 1186 ("Each tortfeasor, on the other hand, was a tortious, actual, and proximate cause of the plaintiff's entire injury and thus bears independent full responsibility for the injury.").

(n227) See supra note 193 on the theory of comparative causation using the probalistic marginal product as a methodology. For other methods, see Leonard Schwartz, The Many Meanings of Comparative Fault: An Economic Analysis of Alternative Methods of Apportioning Liability, 17 N.C. CENTRAL L. REV. 191 (1988).

(n228) How then does the trier of fact set about to apportion damages among the parties? There is, of course, a difference between the apportioning process when undertaken by judge rather than jury. The judge is presumably more versed in the law of evidence and is therefore better able to determine the probative weight to give the facts; she is also more experienced and thus more familiar with how similar apportionments have been resolved in the past; she is aware of the legal consequences of the apportionment ratios; and she need not concern herself with the need to compromise with other fact finders.

However, both judge and juror have to find a starting point. We suspect that the normal inclination is to determine first whether there are any parties before the court without fault. In the jury context, this determination should probably be resolved before going further. Having eliminated the innocent, a reasonable approach, we think, would be next to assign, as a first approximation, pro-rata allocations, then step back mentally and see how comfortable the fit is. It is at this point that true comparison begins. Serious anomalies are quickly manifested as it becomes clear to the triers that A's responsibility for the harm is not equal to B's because it is demonstrably more or less.

For a second approximation it would probably be natural to categorize the various parties' conduct as "slightly," "considerably," or "greatly" responsible for the harm (or some similar verbal formula). Jurors will probably offer reasons why they favor one categorization for a party over another. Their reasoning may or may not persuade others, but it will certainly prove difficult to go forward until this rough

cut is taken and agreed to. The final stage, presumably, will be that of fine tuning (and compromise, if necessary) within the confines of a 100% limit.

Is this how the process really works? We would urge researchers to try to find out, because it is a fascinating question. Should the process always yield roughly the same percentages with similar facts? This result seems likely only to the extent that values are universal and shared throughout society. Inasmuch as the United States is a particularly heterogeneous society, we should expect considerable variation in the apportionment results from case to case and jury to jury. Is this fair? The parties have subjected their dispute to litigation, thus, they are entitled to an orderly process in which fairly chosen triers of fact weigh the evidence and offer their best judgment in good faith. The parties can expect no more than that.

(n229) Wade, supra note 158, at 203 (quoting Guy, supra note 201, at 6).

(n230) Dean Wade understands fully the difference between causation and culpability, but his moral system requires that compensation for injury be linked to causation. He states, "One cannot in good faith make the argument that [one of two negligent automobile drivers who jointly caused an indivisible harm has] paid for all the harm he caused when the apportionment of his responsibility was based only on the measure of his fault." We think one can make such an argument on the ground that proximate cause is no more than an issue of policy. See PROSSER AND KEETON, supra note 4, at 273. If, for example, a railroad causes a fire in an adjacent structure, but is deemed not to have proximately caused the fires spreading to more remote buildings, clearly the causation concept is a slippery basis upon which to apportion damages. See supra notes 145-46 and accompanying text.

(n231) Erwin E. Adler, Allocation of Responsibility After American Motorcycle Association v. Superior Court, 6 PEPPERDINE L. REV. 1, 18-19 (1978).

(n232) Wade, supra note 158, at 202.

(n233) See authorities listed in Blazovic v. Andrich, 590 A.2d 222, 227 (N.J. 1991) (prohibiting or rejecting the comparing of negligent and intentional conduct).

(n234) Id. at 228. (listing authorities permitting or recommending comparison of negligent and intentional conduct).

(n235) Id. at 231.

(n236) See PROSSER & KEETON, supra note 4, at 462.

(n237) Vietor E. Schwartz, Li v. Yellow Cab Co.: A Survey of California Practice Under Comparative Negligence, 7 PAC. L.J. 747, 752-53 (1976).

(n238) Chamberlin v. Fuller, 9 A. 832, 836 (Vt. 1887). See also Wilder v. DeCorr, 18 Minn. 470 (1871) ("[I]f the representations were willfully false, it does not lie in the vendor's mouth to say that the vendee ought not to have relied upon them.").

(n239) In Blazovic the intermediate appellate court objected to apportionment because it concluded that the fault of the parties was "indivisible." The supreme court disagreed: "The feet that the tortfeasors acted separately and are liable on different theories does not preclude apportionment." 590 A.2d at 232. The court also rejected the idea that, if the negligent party is assessed a percentage of the fault, it should have a right of indemnity against the intentional tortfeasor. The court concluded that apportioning fault in such eases will not under-deter intentional wrongdoers in future eases because it rejected the proposition that intentional and negligent wrongdoing were different in kind rather than degree. Thus, the principle of proportionality of damages takes into account differences in conduct, no matter how those differences are labeled. 590 A.2d at 233.

(n240) Lynn v. Taylor, 642 P.2d 131 (Kan. Ct. App. 1982).

(n241) Id. at 135. The defendant argued that Kansas had abrogated joint and several liability in comparative fault eases.

(n242) Id. at 136.

(n243) PROSSER & KEETON, supra note 4, at 462. The discussion refers to the contributory negligence defense where the defendant has acted intentionally, but the principle has been extended to comparative fault. See Florenzano v. Olson, 387 N.W.2d 168, 175 & n.7 (Minn. 1936); Schulze v. Kleeber, 103 N.W.2d 560, 564 (Wis. 1960).

(n244) 590 A.2d at 231.

(n245) Id. at 231.

(n246) Id. at 227.

(n247) Id. at 227 (quoting Suter v. San Angelo Foundry & Mach. Co., 406 A.2d 140, 148 n.6 (N.J. 1979)).

(n248) Id. at 232-33.

(n249) Actually, the statute provides that joint and several liability is abrogated when the defendant is found to be 20% or less at fault, and is abrogated only with respect to noneconomic loss for defendants found more than 20% but less than 60% at fault. See supra note 223.

(n250) Id. at 233.

(n251) Id. at 233.

(n252) 461 A.2d 138, 152.

(n253) 461 A.2d 138, 152 (N.J. 1983).

(n254) See supra note 155 and accompanying text.

(n255) 590 A.2d at 321-32.

(n256) 388 N.W.2d 908 (Wis. 1986).

(n257) Id. at 911.

(n258) Id.

(n259) 159 Cal. Rptr. 778 (Cal. Ct. App. 1980).

(n260) Id. at 781. Accord Braswell v. People's Credit Union, 602 A.2d 510 (R.I. 1992).

(n261) Id.

(n262) "The trial judge's comments ... show he used the word 'overt' as a synonym for 'intentional' to indicate an absence of scienter necessary for fraud." Id. at 780.

(n263) 789 P.2d 960 (Cal. 1990).

(n264) 789 P.2d at 970.

(n265) 512 NE.2d 1141 (Mass. App. Ct. 1987).

(n266) Id. at 1143.

(n267) Id.

(n268) Id.

(n269) Florenzano v. Olson, 387 N.W.2d 168 (Minn. 1986).

(n270) Id. at 176.

(n271) Id. at 176 (quoting WILLIAM PROSSER, LAW OF TORTS 5 107, at 706 (4th ed)).

(n272) WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW (1987) [hereinafter ECONOMIC STRUCTURE|.

(n273) See id. at 16-19. Landes and Posner use the term "efficiency" throughout their book in the Kaldor-Hicks (or potential Pareto superiority) sense, in which a policy change is said to be efficient if the winners from the exchange could compensate the losers, that is, if the winners gain more from the change than the losers lose, whether or not there is actual compensation. Another way of stating the Kaldor-Hicks criterion is in terms of wealth maximization. Id. at 16. Landes and Posner "do not argue that tort law is efficient in the strict Pareto-superior sense," Under Pareto superiority no person should be worse off because of a change. Such a system would require injurers to compensate victims in the absence of negligence, because if they did not the injurers might be better off but victims would be worse off. However, common law negligence rules may be efficient in the Pareto-superiority "on an ex ante (before the fact) basis." Id. at 17. For our analysis in this article we accept the Landes-Posner/Kaldor-Hieks definition of efficiency.

(n274) See id. at 59. The social costs of accidents is defined "as the sum of the expected accident losses and the costs of care (or avoidance)."

(n275) Landes and Posner generally are contemplating personal injury or property damage accidents involving strangers, but their analysis and model is also useful for analyzing pecuniary losses caused by misrepresentations in transactions if the parties are more closely related.

We have assumed for this analysis what Kornhauser and Revesz call a negligence regime of "full liability" rules. These authors point out that accidents can occur in the absence of negligence. Thus, it can be argued that "partial liability" rules would provide adequate deterrence. Under partial liability the victims' damages would be discounted by the probability of harm occurring through acts of non-negligent actors. For example, if there is a 20% probability that a creditor will be unable to collect a $1000 debt in the absence of negligence, but in feet there is negligence, then his recovery under a partial liability rule would be limited to $800. Kornhauser & Revesz, Sharing Damages, supra note 158, at 837-40. These authors note that commentators are split as to whether common law courts follow full or partial liability rules. Id. at 839-40. We think it unlikely that courts will seek reduction of damage awards commensurate with the "background" probability of losses occurring to creditors, guarantors, and investors in the absence of negligence.

(n276) See William M. Landes & Richard A. Posner, Joint and Multiple Tortieasors: An Economic Analysis, 9 J. LEGAL STUDIES 517, 518 (1980) [hereinafter Joint and Multiple Tortfeasors]. In the alternative care ease "optimal accident avoidance requires that only one potential injurer take care." An example given is "where a product defect that causes an injury would have been prevented if either the manufacturer of the defective component had been more careful or the manufacturer of the final product had inspected its components more carefully." Id. The auditor's case would appear to offer a close fit; harm to third parties would be avoided if either the client reports the truth or the auditor discovers a misrepresentation and sets it right. In contrast, the "joint care" case requires both parties to take care. Id.

We believe the Landes-Posner model would find that the auditor's case is "simultaneous rather than successive" because in the latter instance "one tortfeasor aggravates an injury inflicted by the other." Id. But when an auditor fails to detect a client's misrepresentation, the two parties' acts produce a single unaggravated injury to the third party creditor, guarantor, or investor.

(n277) Id. at 526.

(n278) ECONOMIC STRUCTURE, supra note 272, at 200.

(n279) Id.

(n280) Id.

(n281) Although H. Rosenblum does not explicitly deal with the issue of back-up liability as such, it is generally the case that an auditor is sued only when its client defaults, or is likely to default, on its obligations.

(n282) ECONOMIC STRUCTURE, supra note 272, at 201-12. A rule of comparative fault when there are multiple tortfeasors is, in effect, a rule of comparative contribution. Id. at 197.

(n283) Id. at 201-03. Landes and Posner point out that even pro rata contribution is expensive because additional lawsuits may be required to identify all the potential tortfeasors. They dismiss the idea of allowing defendants to seek contribution from nonparties because "this is a costly process that a system of law dominated by efficiency concerns would not consider worthwhile." Id. at 202. We would argue that a comparative contribution rule for apportioning damages in which the wrongful conduct of immune, insolvent, and settling parties is considered would not be unreasonably burdensome. Actually, Landes and Posner recognize the improvement that such a comparative fault approach would provide, finding that it is "relatively simple and protects the interests of all defendants, but it results in lower recoveries for plaintiffs, and it requires a judgment of relative fault." Id. at 203. Inasmuch as plaintiffs in auditor/third party cases can protect themselves ex ante by contract, see infra notes 356-74 and accompanying text, the only additional transaction cost involved in the ex post tort action would be the relatively modest cost of administering a special verdict.

(n284) ECONOMIC STRUCTURE, supra note 272, at 193. Landes and Posner are responding here to arguments raised by PROSSER AND KEETON, supra note 4, at 337-38. Landes and Posner claim that Prosser and Keeton have failed to keep "fully abreast of the economic analysis of their subject; our analysis of contribution, to which they make no reference...." ECONOMIC STRUCTURE, supra, at 172 n.5.

(n285) ECONOMIC STRUCTURE, supra note 272, at 13. Landes and Posner acknowledge that, if potential injurers and insurers have insufficient resources to be fully responsible financially, an externality is created. Id. To deal with this possibility they accept the less than optimal solution of "back-up liability." See supra notes 279-81 and accompanying test.

(n286) Joint and Multiple Tortieasors, supra note 276, at 521.

(n287) This assumption was explicitly relied on by the court in H. Rosenblum v. Adler, 461 A.2d 138, 152 (N.J. 1983) ("Much of the additional costs incurred either because of more thorough auditing review or increased insurance premiums would be borne by the business entity and its stockholders or its customers.").

(n288) Misstatements in financial statements occur because of client "errors" or "irregularities." An error is defined as an unintentional mistake in either interpreting

or applying generally accepted accounting principles (GAAP). See AICPA PROFESSIONAL STANDARDS, U.S. Auditing Standards AU Section 316.02 (Am. Inst. of Certified Pub. Accountants (CCH) 1990). An irregularity is an intentional misstatement of financial information perpetrated by either the client's management or employees. Id. at AU Section 316.03. See also Craig A. Brumfield et al., Business Risk and the Audit Process, J. ACCT., April 1983, at 60 [hereinafter Business Risk].

(n289) The auditing profession recognizes a broader concept known as "business risk," which includes -- with other threats to the accounting firm -- the probability of loss from judgments and settlements of litigation. Business Risk, supra note 288, at 60.

There are several principal grounds under which auditors are sued by their clients and relying third parties for negligently representing in unqualified audit reports that the audited entity's financial statements fairly represent the financial condition of the entity, when in feet they do not. According to auditing professional pronouncements, auditors are responsible for detecting all material misstatements that affect the fairness of the financial statements presented by the client company. AICPA PROFESSIONAL STANDARDS, U.S. Auditing Standards AU Section 312.13 (Am. Inst. Of Certified Pub. Accountants (CCH) 1990). The types of errors and irregularities that auditors have failed to detect can be divided into the following four categories: (1) revenue recognition issues; (2) asset valuation issues; (3) other conditions not conforming to GAAP; and (4) other irregularities.

Revenue Recognition Issues: Revenue recognition issues include misstatements that affect the income statement; typically, they inflate revenues as well as profits of the company being audited. One example is an improper sales cutoff. This occurs when a sale by the client company is recognized in the wrong fiscal period (e.g., a 1992 sale is reflected in the 1991 Income Statement, thereby inflating sales for 1991).

In the following three instances, the issue is whether the transactions involved are bona fide sales. The first involves recording a sale under a bill-and-hold agreement. This occurs when the sale is billed to the customer and recorded; however, the merchandise is not shipped at that time. The question is whether title passed when the sale was billed and recorded or when the merchandise was subsequently shipped. In the second instance the issue is whether transections should be recorded as sales when the related shipments are made to third parties who are authorized to accept the goods on behalf of the buyers. In this scenario, the questions are which third parties are "authorized" by the actual customers, and whether these are bona fide sales. The third instance involves the recording of a sale in which there are written or oral rights of return and the chance of such return is not remote. If it is reasonably possible or probable that the merchandise sold will be returned, the issue is whether a sale was actually consummated between the client company and the customer.

Another revenue recognition issue is raised by the treatment of operating leases as sales. An operating lease occurs when the lessor intends that title shall not pass to the lessee at the end of the lease term and no rights to ownership are conveyed to the lessee by the lessor through the terms of the lease agreement. Under an operating lease, the rents should be recorded by the lessor when earned, and no sale of property should be recorded by the lessor. If an operating lease is erroneously recorded as a sale, revenues will be inflated.

Another instance is the non-recording of a sales return. This occurs when merchandise is returned for credit and the return is not recognized, either by the seller failing to issue a credit memorandum or by not recording a credit memo that has been issued. Because gross sales are netted against sales returns to yield net sales, the effect of this error or irregularity is to overstate net sales.

Asset Valuation Issues: A second category of issues includes items that primarily affect the balance sheet, typically inflating the value of the assets listed. As a general rule, GAAP require that most assets and liabilities be reflected in the financial statements at historical cost. DONALD E. KIESO & JERRY J. WEYGANDT, INTERMEDIATE ACCOUNTING 35 (6th ed. 1989). Hence, the first example in this category includes the situation in which there is the improper assignment of costs to the related assets, especially in an account such as inventory.

This situation can arise when the documentation supporting the unit cost is incorrect due to erroneous dating or amounts.

A second example involves a misstatement of market price. For some assets, the determination of market value as well as cost is essential for valuation and disclosure purposes. Two asset classifications that are particularly affected by this rule are inventories, 2 ORIGINAL PRONOUNCEMENTS, Accounting Standards 16 (Fin. Accounting Standards Bd. 1990), and marketable securities, 1 ORIGINAL PRONOUNCEMENTS, FASB Statements of Standards 86 (Fin. Accounting Standards Bd. 1990). According to GAAP, these assets must be reflected in the balance sheet at the lower of cost or market. Problems in determining historical cost have been mentioned, but the assessment of market price can be even more problematic. This has been particularly true in the savings and loan crisis in which repossessed real estate held by financial institutions was based on appraised value (which was lower than cost) that proved to be erroneous for a variety of reasons. Hence, even though GAAP was followed, the market value was too high, thereby inflating the value of the related asset.

Another problem in asset valuation is the determination of net realizable value. Certain asset accounts must be stated in the balance sheet at their net realizable value such as accounts, notes, and loans receivables. For example, gross accounts receivable, net of the allowance for uncollectible accounts, must be reflected in the balance sheet at net realizable value. This value represents the amount that management in good faith believes will ultimately be collected in cash on the receivables outstanding. Therefore, when the collectibility of a receivable amount is questionable, an amount must be included in the allowance to reflect that portion of the receivable balance deemed to be uncollectible. See, e.g., International Mortgage Corp. v. John P. Butler Acct. Corp., 223 Cal. Rptr. 218 (Cal. Ct. App. 1986) overruled by Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992) (accounting firm sued by third party because the assets reflected in client's financial statements were greatly overstated due to inclusion of worthless notes receivable). Without this allowance, net receivables could be inflated.

Another asset valuation-related issue is the lack of disclosure of a "going-concern" problem. Failure to assess this situation properly poses a significant risk of litigation to the auditor. If the auditor does not recognize that a client company is unlikely to survive beyond one year hence, the asset and liability values reflected in the balance sheet at historical cost are not appropriate. As already mentioned, GAAP requires that assets be reflected in the financial statements at historical cost with certain qualifications for specific asset classifications (i.e., lower of cost or market, net realizable value). This GAAP requirement, however, assumes that the client company is a going concern. See, e.g., Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968) (auditor issued unqualified opinion indicating client was solvent when this was not true). If the company is not a going concern, a liquidation approach would be used in which asset values would be better stated at net realizable value rather than at acquisition cost. See Kieso and Weygandt, supra, at 34.

Other Conditions Not Conforming to GAAP: The third category includes all nonconforming GAAP conditions that are neither revenue recognition problems nor asset valuation problems. For example, using a non-GAAP method of accounting typically has serious consequences for the fair presentation of the financial statements, especially when the effect of the misstatement on those financial statements is material. Although there are rare cases in which GAAP need not be followed (e.g., new forms of business transaction), see 2 AICPA PROFESSIONAL STANDARDS, Code of Professional Conduct ET Section 203.02 (Am. Inst. Certified Pub. Accountants (CCH) 1990), in the usual circumstance, GAAP is to be followed. When it is not and the auditor fails to discover it, an unqualified audit opinion rendered on the related financial statements is incorrect. See ALVIN A. ARENS & JAMES K. LOEBBECKE, AUDITING: AN INTEGRATED APPROACH 110 (5th ed. 1991). GAAP also requires the disclosure of all material related party transactions. See 1 ACCOUNTING STANDARDS, FASB Statements of Standards 553 (Fin. Accounting Standards Bd. 1990). If the auditor does not discover, and is therefore unable to require disclosure of a transaction of this type, the related financial statements are not fairly presented. In United States v. Simon, 425 F.2d 796 (2d Cir. 1969) (the "Continental Vending" case), the auditors failed to discover the magnitude of a related party transaction because of the client's practice of netting receivables and payables from the same company. As a result, the net impact to the audited company appeared insignificant even though the receivable could not be repaid by the related party. See WALLACE, supra note 57, at 260. GAAP requires this disclosure because transactions consummated between related parties (i.e., officers, directors, subsidiaries, affiliates, etc.), are not at arms' length. Therefore, there is the likelihood that the transfer price may not be at fair market value. If the transfer price is below fair market value, the stockholders and/or creditors will be financing the differential and should know it.

Another area of potential litigation is when there is inadequate disclosure of a "probable" material uncertainty in which "there is a reasonable possibility that the outcome will be unfavorable," see Kieso and Weygandt, supra, at 604, such as litigation between the client and another party (e.g., customer, vendor, or competitor). Such a contingency could certainly affect an investor's or creditor's assessment of the quality of his investment or loan. Improper deferral of costs is another problem. As a general rule, for the financial statements to be reflected in accordance with GAAP, costs need to be expensed when incurred. However, it is sometimes difficult to determine this date, especially when one is dealing with estimates. Id. at 38. Expense and revenue recognition are complex issues. Typically, the "expense recognition is tied to revenue recognition.... This practice is referred to as the matching principle because it dictates that efforts (expenses) be matched with accomplishment (revenues) whenever it is reasonable and practicable to do so." Because deferring expenses is equivalent to reflecting costs that have already been incurred as an asset, expense deferral has been used by some clients to manipulate or "smooth" income.

Other Irregularities: Lapping is an irregularity committed by the client's management or employees, which is intended to hide a theft of cash by manipulating the application of cash receipts to accounts receivable. See, e.g., WALLACE, supra note 57, at 267 (discussing settlement of lawsuit brought against Arthur Andersen & Co., involving their client Frigitemp, in which various collusive fraudulent practices, including lapping, went undetected by the auditors). Another client irregularity is kiting. Kiting occurs when the cash balance is overstated, typically by means of bank transfers and float. Still another irregularity involves the embezzlement of company funds by management or an employee, see, e.g., LARRY F. KONRATH, AUDITING CONCEPTS AND APPLICATIONS: A RISK-ANALYSIS APPROACH 61 (1989) (discussing an instance when Touche Ross & Co. successfully defended itself in 1982 for failing to detect an embezzlement scheme by the management of Cedars of Lebanon Hospital Corp., the court ruling that "management cannot sue an auditor for failing to detect a fraud that management itself perpetrated"). If material, one would expect that this fraud would be discovered during the audit engagement.

"Validity of the accounts" is a problem related to receivables and inventories. Auditors have been sued because the financial statements reflected accounts receivables that were fictitious. See, e.g., Ultramares v. Touche, 174 N.E. 441 (N.Y. 1931) (audited company's accounts receivables included fraudulent amounts that more than doubled the true size of the balance) or because inventories on the books did not exist. See KONRATH, supra, at 78 (describing McKesson & Robbins case, ultimately settled in 1938, in which a significant portion of accounts receivable were fictitious and a large amount of inventory was nonexistent). This case precipitated the auditing standard which now requires auditors to confirm accounts receivable and observe inventory on a sample basis. See 1 AICPA PROFESSIONAL STANDARDS, U.S. Auditing Standards AU Section 331.01 (Am. Inst. of Certified Pub. Accountants (CCH) 1990). Obviously, if nonexistent assets are reflected in the books and records, total assets will be inflated by the dollar amount assigned to the fictitious assets.

(n290) What follows in text is a garden variety application of the Learned Hand Rule. See United States v. Caroll Towing Company, 159 F.2d 169, 173 (2d Cir. 1947).

(n291) See 1 AICPA PROFESSIONAL STANDARDS, U.S. Auditing Standards AU Section 150.02, at 81-82 (Am. Inst. of Certified Pub. Accountants (CCH) 1990).

(n292) See id., Statement on Auditing Standards No. 58 Section AU 508.08 ("In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position ... and the results of its operations and its cash flows ... in conformity with generally accepted accounting principles."). Materiality is defined by accounting standards as "[t]he magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." 2 ORIGINAL PRONOUNCEMENTS, Accounting Standards, FASB Concepts Statements 706 (Fin. Accounting Standards Bd. 1990). Hence, auditors do not assert to financial statement users that the audited financial statements are completely accurate. Instead, they attest that the financial statements are materially correct. Therefore audited financial statements are likely to contain some misstatement deemed immaterial by the auditors.

The management of the client company is responsible for the accuracy of the financial statements. ARENS & LEOBBECKE, supra note 289, at 36. The fact that an audit is performed by an independent party does not relieve management of its responsibility for both fair and accurate presentation of the financial information. Any material misstatements in the audited financial statements remain the responsibility of management.

(n293) See Jennings et al., supra note 102, at 100-01.

(n294) See supra note 292. See also Jennings et al., supra note 102, at 103 and n.15. Quantitative definitions of materiality have proved to be elusive. Different authorities use different bases of financial activity as benchmarks: e.g., earnings per share; consolidated revenues; gross profit; and a combined base of income, assets, and profit.

(n295) See id. at 104 n.22 citing eases. See also supra note 57 discussing Bily v. Arthur Young and Co., 271 Cal Rptr. 470 (Cal. Ct. App. 1991) rev'd on other grounds, 834 P.2d 745 (Cal. 1992).

(n296) Under negligence principles serious injury can occur in the absence of negligence if a reasonable calculation of potential harm was made and guarded against, but either the improbable event occurred or the injury was more severe than could reasonably have been anticipated.

(n297) In Business Risk, supra note 288, the authors advise auditors to conduct more stringent audits than GAAS requires when the auditors perceive that their liability risk has increased. In short, they urge that GAAS requirements should be treated as a minimum standard.

(n298) See supra note 102 and accompanying text.

(n299) The actual reliance argument is based on cause-in-fact. If X number of creditors and investors use their own information (or perhaps ouija boards) exclusively to make their business decisions while ignoring audit opinions, presumably, they should be unable later to maintain lawsuits against the auditors for negligent misrepresentation. See supra note 5 and accompanying text.

(n300) Richard A. Epstein, Liability of Accountants for Negligence: How To Tell the Best Rule? in BUSINESS LAW 1134 (Mark E. Roszkowski ed. 1987).

(n301) Although insurance companies have significant incentives to reduce the risks they contract to bear, they rarely have the expertise or the resources to do much more than a superficial job of monitoring. It is difficult enough for auditors to obtain some expertise in their clients' businesses, how much less expert must the auditors' insurers be in assessing the insolvency risks of those same businesses?

(n302) We do not include here dispute resolution costs (primarily attorney fees). These, of course, are horrendous. When tort litigation costs are included in the overall administration of claims, generally less than a third of insurance premiums are returned to victims to compensate them for their injuries. See, e.g., authorities cited in ECONOMIC STRUCTURE, supra note 272. at 57-58 nn.9-10. Although this performance relates to product liability and motor vehicle crash experience, there is little reason to believe other tort areas are cheaper to administer.

(n303) It is important to distinguish the insurance mechanism from the tort system per se. The latter serves efficiency by deterring unsafe behavior, but at a huge loading cost. ECONOMIC STRUCTURE, supra note 292, at 58. The insurance mechanism provides some minimal additional deterrence through monitoring of the risk environment, but savings from that score is more than offset by insurance transaction costs. Moreover, as Landes and Posner point out, normally risk averse behavior becomes converted to risk neutral behavior when parties are fully insured. Id. Moreover, economists argue that, when parties are insured a moral hazard exists that operates to increase the frequency of accidents. See infra note 325 and accompanying text.

(n304) PLI amounts will probably increase for two reasons: the potential plaintiff class is greater, and the potential loss that this larger class may suffer is more difficult to calculate. We assume that accountants generally will buy insurance "conservatively," i.e., they will assume that an uncertain risk is more closely aligned with the worst case scenario than with the best case one. We concede that this assumption based on the accounting principle of conservatism requires empirical testing but it is consistent with observed behavior that persons are generally loss averse. See infra notes 330-31 and accompanying text.

(n305) See supra notes 300-03 and accompanying text.

(n306) See infra notes 311-28 and accompanying text.

(n307) Shifting risk by contract is not cost free, but it is generally more cost effective than ex post tort litigation.

(n308) See generally Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FINANCIAL ECON. 305 (1976) reprinted in THE MODERN THEORY OF CORPORATE FINANCE 82 (Clifford W. Smith Jr. ea., 2d ed. 1990). This seminal work defines "residual loss" as the "divergence between the agents' [e.g., junior accountant's! decisions and those decisions which would maximize the welfare of the principal [i.e., the CPA firm]." Id. at 85. Cf. Thomas Petzinger Jr., Price Waterhouse Ex-Aide Got Funds Linked to BCCI, WALL ST. J., Feb. 25, 1992, at C11 (reporting that former employee, now retired in Cayman Islands, received $100,000 from BCCI affiliate two years after leaving firm). Although PW's own investigation revealed no connection between the payment and the audit, the story illustrates the potential agency problem in assessing the probability of the firm's being held liable for tortious conduct. We would argue that determining the anticipated "residual loss" for an accounting firm's employees, and even its individual partners, is a highly uncertain calculation.

(n309) Many businesses go through periods when their survival is precarious, but most of them weather these storms. If they do the bills are paid and the stock goes up, but often their fates are in the hands of the gods who control the business cycle. See Paul Craig Roberts, Scapegoats for the Failure of Public Policy, INDIANAPOLIS STAR, June 20, 1992, at A6 (arguing that in misrepresentation suit by British bank purchaser of Arizona bank, in which jury verdict of $335 million was rendered against Price Waterhouse, the real culprit was Congress, whose real estate policy changes "suddenly yanked the rug out from under real estate" a year after audits had been completed and disseminated). See, e.g., Berton and Adler, supra note 5 ("In defending its 1985 and 1986 audits, Price Waterhouse mainly blamed [investor! United's losses on the Arizona real-estate crash and other market related setbacks after the closing.").

(n310) When a business fails parties are often sued for having failed earlier to disclose the precariousness of the enterprise's financial situation. Public disclosure, however, would almost certainly have lessened the chances of survival. Thus, when auditors seek to calculate a "risk-of-insolvency-component" as part of the fee they will charge, they are likely to receive minimal and misleading information from their clients on this score when they most need accurate information.

(n311) See, e.g., Lee Berton, Accounting Profession, Once a Staid Field, Is Torn by Incivility, WALL ST. J., July 24, 1991, at A1 (pointing out that falling revenues from increased competition, but with public liability insurance tripling to $12,500 per accounting firm partner in five years, is forcing many CPA firms out of business).

(n312) See id.

(n313) See supra note 69-91 and accompanying text. See also Blowing the Whistle on Accountancy, THE ECONOMIST, Aug. 22, 1990, at 15.

The big eight firms became the big six as they merged and remerged, struggling to push under one roof a whole range of business services, like tax advice, management consultancy, corporate finance, and, yes insolvency. This left them woefully dependent on non-recurring fee businesses like consulting; it also encouraged them to cut auditing charges to win other businesses. (emphasis added)

See also Berton and Adler, supra note 5 ""Seeking to keep the work, Price Waterhouse ... offer[ed] to remain United's auditor for $140,000 a year, which some auditors term about half the going rate. Offering attractive fees to get or keep auditing work was fairly common in the mid-1980s as competition intensified."). Although there have been warnings that CPA firms will drastically reduce their audit services and will dramatically raise their audit fees - and there is some evidence that this may be happening, see Lee Berton, Legal Liability Awards are Frightening Smaller CPA Firms Away From Audits, WALL ST. J., Mar. 3, 1992, at B1, we believe that, in the absence of structural change, any trend towards less competitiveness for audit engagements will prove to be a temporary phenomenon.

(n314) See id. ("When auditing becomes a loss-leader it is scarcely surprising that it gets done badly or misleadingly."); see also Washington Update, J. ACCT., June 1986, at 50. "[B]illion dollar losses by investors are not beyond contemplation, yet auditors' fees cannot be expected to grow commensurately, and the ability of auditors to respond to massive damage claims could threaten the viability of the profession and reduce the quality and scope of services that the profession can provide." Id. (quoting Ray J. Groves, chairman of the AICPA's special committee on accountants' legal liability). Many fair-minded observers would rate Mr. Groves's 1986 prediction right on target.

(n315) See, e.g., Medniek, supra note 196; David A. Olsen, Let's Have Fair Play for the C.P.A., N.Y. TIMES, Dec. 29, 1991, at 13.

(n316) Increased auditing costs are justified, of course, if third parties gain more than auditors and their clients lose by the change, that is, unless an alternative change would produce an even more efficient result.

(n317) E.g., larger samples, closer supervision, more experienced line auditors, more vigorous follow-up of intuitive suspicions of dubious client behavior, and more stringent questioning of the client's treatment of various transactions under GAAP. For alleged failures with respect to the last four of these areas, see Berton and Adler, supra note 5. The authors note the assignment of a 26-year-old junior auditor to review a large bank loan file, which was never "seen or reviewed by the partner in charge." Also, one expert witness testified that the "once-over-lightly" procedures of the client's loan committee "should have alerted an outside auditor that the bank's internal control could cause problems." And with respect to the client's internal use of GAAP, after conducting ten reviews in 1985 and 1986, Price Waterhouse found no adverse accounting treatments of many loans that later went sour.

(n318) For example, simply increasing the sample size of the tested transactions does not tighten proportionately the confidence levels on which the audit opinion is based.

(n319) See supra note 308 and accompanying text.

(n320) See infra notes 349-55 and accompanying text for discussion of proposals to change this status.

(n321) See ECONOMIC STRUCTURE, supra note 272, at 56 ("Generally people are assumed to be risk averse"). But see Amos Tversky & Daniel Kahneman, Rational Choice and the Framing of Decisions, 59 J. Bus. S251, S258 (arguing "that the response to losses is more extreme than the response to gains" and this leads to risk seeking behavior, which can be explained in terms of an "aversion to losses").

(n322) Self-insuring is cheaper than transacting with an insurer, but for most entities that course means bearing the risk of unfortuitous extinction, a risk most organizations find unacceptable. "The purchase of insurance is intelligible only on the assumption of risk aversion: because of administrative costs, the insurance premium is always greater than the value of the insurance." ECONOMIC STRUCTURE, supra note 272, at 56 n.5.

(n323) See supra note 301 and accompanying text.

(n324) See supra notes 302-03 and accompanying text.

(n325) See Carl Shapiro, Symposium on the Economics of Liability, 5 J. ECON. PERSPECTIVES, 1, 5 (1991). " This moral hazard problem is mitigated, but cannot be eliminated when insurance companies monitor their policy holders ...." Id. at 6 n.6.

(n326) Actual pricing of insurance lines is much more complex than merely setting a premium based solely on assessed risk. First, insurance is a product produced by a competitive, cyclical industry. Its pricing must respond to market forces. Second, insurance pricing is often a function of anticipated investment income on assets held against reserves, as well as anticipated margins in excess of loss experience. Third, premium pricing is subject to state regulation.

Over time, however, the premium must reflect estimated future losses and must make up for past losses that proved to be greater than earlier estimates. If there seems to be developing a litigation growth sector, the prudent insurer will seek to stay ahead of the curve, even at the risk of pricing itself out of that particular market. Our conclusion is that increased uncertainty increases insurance transaction costs. See Epstein, supra note 300, at 1134 ("The absence of privily also makes matters more difficult for the accountant's insurer, which must be able to estimate the accountant's future losses to set its own premium. Privity has at least one unsuspected virtue. It aids in the quantification of relevant business risks.").

(n327) See Sherry R. Sontag, Soured Deals Snag More Professionals, NAT'L L.J., Feb. 4,1991, at 1 (quoting Paul V. Geoghan, assistant general counsel of the D.C. AICPA, who notes that premiums have tripled in three or four years and "some accountants are going bare").

(n328) "Last year saw also the collapse of another major firm, Laventhal & Horwath, which sought bankruptcy protection from creditors after costly malpractice lawsuits." Berton, supra note 311. The "going bare" strategy is not foolproof, however. See WALL ST. J., Oct. 7, 1991 at B7 ("New suits may be filed against partners of defunct accounting firm [Laventhol and Horwath).").

(n329) See supra note 302 and accompanying text.

(n330) See Tversky & Kahneman, supra note 321, at S259-60. The authors argue that a significant property of the value function is loss aversion. Whereas most persons are generally risk averse, when faced with losses, they exhibit risk seeking behavior. As the loss potential increases, the utility of risk seeking behavior increases for more persons. Thus, a tort defendant looking at a choice of taking a 50% chance of losing $1 million by going to trial or settling for $500,000 would be more likely to litigate than one facing a choice of taking a 50% chance of losing $100,000 at trial or settling for $50,000.

Parties looking at potential gains, however, will exhibit risk averse behavior and will be more likely to opt for the bird-in-the-hand. But Tversky and Kahneman's analysis posits that the value curve in the loss quadrant is much steeper than in the gain quadrant. Thus, it would appear to follow that a defendant's loss aversion/ risk seeking behavior will outweigh a plaintiff's efforts to avert risk by offering to settle - assuming, of course, that the plaintiff views a potential judgment in his favor as a gain. We would argue instead that victim-plaintiffs are more likely to view themselves as temporary losers seeking to recover the status quo ante. Their psychological reference points are not their wealth levels at time of trial, but rather the levels they had prior to the defendants' wrongful acts. They too will exhibit risk seeking behavior to avoid making their losses permanent, just as a casino gambler tends to double up when he is behind.

The joint and several rule does not affect the plaintiff's position but it does raise the stakes for the individual deep pocket defendants who can meet a judgment. Given Tversky and Kahneman's persuasive analysis, we can expect under the joint and several rule more trials and appeals, and fewer settlements.

Cf. Harlan, supra note 25. When the jury verdict of $200 million in punitive damages was announced against Coopers & Lybrand, the firm said "it was 'outraged' by the verdict. `We intend to mount a vigorous appeal to what we believe is a vastly excessive and unconscionable award.... Our firm has the financial resources and the will to exercise all its legal options." Another defendant in the ease said it expected "the appeals process to take years." Id. Although the ease was settled shortly thereafter, see supra note 183, we believe it was because the parties were sure the massive punitives would lead to a new trial, the outcome of which was very uncertain. In as much as the plaintiffs at this point were probably well within the domain of gains after the settlement offer, they no doubt resorted to risk averse behavior and settled.

(n331) See Tversky & Kahuman, supra note 321, at S262 (Referring to the work of M.H. Bazerman the authors state, "Subjects who bargained over the allocation of losses more often failed to reach agreement and more often failed to discover a Pareto-optimal solution.").

(n332) See Medniek, supra note 196, at 121-22.

(n333) See Herskovitz, supra note 6, at 21.

(n334) There certainly have been a great many articles in law reviews, bar journals, daily press, and general news periodicals setting out both sides of the liability-to-third-party issue. As one set of authors have found, however, there still remain substantial differences in viewpoint between judges and auditors on the issues. See Jennings et al., supra note 102. The fact that this and previous studies by these authors have involved members of the National Judicial College as subjects would suggest that those judges, at least, are likely to be more knowledgeable about (if not more sympathetic to) auditor attitudes after their participation in these studies than before.

(n335) See supra note 304 and accompanying text.

(n336) At present an auditor's qualified opinion sounds a shrill alarm. The effect on the enterprise's ability to find investment capital and credit is immediately and negatively affected. If qualified opinions become more common, the alarm will perhaps come to be less shrill, but the uncertainty of the messages being communicated to the capital markets must nevertheless translate into higher borrowing rates and lower stock prices.

(n337) See supra note 285 and accompanying text.

(n338) See supra notes 278-79 and accompanying text.

(n339) See supra note 280 and accompanying text.

(n340) See ECONOMIC STRUCTURE, supra note 272, at 193. In this discussion, Landes and Posner focus on risk allocation among potential joint tortfeasors. So long as the anticipated losses are assigned to all potential defendants ex ante, the defendants will be deterred, even if ex post a no contribution rule causes one to pay more than his equitable share. Similarly, it can be assumed, that if it is feasible for the plaintiffs to negotiate the allocation of risk with their potential injurers ex ante -- and it is not deemed against public policy to do so -- then efficiency would be served by such risk shifting contracts.

(n341) See Goldberg, supra note 225, at 295. Professor Goldberg argues that contractual arrangements are entirely sufficient to protect third parties from auditor negligence. We believe, however, that the financial community will demand more assurance; that audit opinions, to receive the credibility commensurate with the diligence invested in them, will have to be supported by potential tort liability for auditors who deviate from the standard of due care. See infra notes 372-73 and accompanying text.

(n342) See supra note 27 citing press reports of third parties apparently taken by surprise by auditors' failure to report adequately the financial condition of failing enterprises.

(n343) See supra note 220 and accompanying text.

(n344) See supra notes 330-31 and accompanying text.

(n345) At one time the "brand names" of prestigious auditing firms provided users of financial information with adequate indices of quality. See, e.g., Berton and Adler, supra note 5 (in seeking to retain an account after it had been acquired in a merger, "Price Waterhouse also cited its overall reputation...,"). But certainly, these brand names have been permitted to erode in recent years. Perhaps the AICPA should consider approving the design of "super audits" that far exceed GAAS requirements, which clients could purchase to impress the financial markets.

(n346) See LIKIERMAN REPORT, supra note 99.

(n347) Id. at 10 (summary), 17-87.

(n348) Id. at 1-10.

(n349) 2 AICPA PROFESSIONAL STANDARDS, Code of Professional Conduct ET 5 505.01 (Am. Inst. of Certified Pub. Accountants (CCH) 1990).

(n350) See Lee Berton & Joann S. Lublin, Partnership Structure Is Called in Question As Liability Risk Rises, Wall St. J., June 10, 1992, at A1; Thomas W. Rimerman, The Need for Expanding Organizational Options for CPAs, J. ACCT., Oct. 1991, at 45; Accountants' Body Is Moving Toward Limiting Liability, WALL ST. J., August 3, 1990, at C5.

The state statutes authorizing establishment of professional corporations vary with respect to whether they impose vicarious personal liability on non-negligent shareholders for the torts of negligent shareholders. A number of statutes appear to provide such protection, but personal liability for the shareholder's own torts and for those of employees he directly supervises definitely remains. Special problems also exist for professional corporations seeking to carry on multistate and international practice. See Leo C. Moerson, Wearing an Eyeshade and a Veil:

Limiting Accountants' Liability for Malpractice, in Selected Papers, Am. Bus. L. Ass'n. Nat'l Proc. (1986).

(n351) The amount of PLI or PII (professional indemnity insurance) to be considered adequate could be a significant issue in a regime of uncertain and virtually open-ended auditor liability. Were damages to be statutorily capped, the statutory coverage could be tied to the cap amounts. See, e.g., LIKIERMAN REPORT, supra note 99, at 29, describing the proposed Australian scheme of statutory capping in which "an accountant should be required to have non-cancellable PII on a scale which would enable him to meet a claim for the largest amount for which he could be liable under the capping system...." The proposed coverage requirement contains numerous other provisions. Id. The Report observes, however, that "[n]o insurance policy for accountants will ever cover the cost of compensating for the gross liabilities of a large bank or the takeover value of a large public company." Id. at 37.

(n352) See, e.g., Neil Barsky & Susan Pulliam, Life Insurers' Loans On Real Estate Cause Ever-Rising Worries, WALL ST. J., Jan. 31, 1992, at 1 (noting that the poorly performing real estate loan portfolios of life and life & casualty insurers is threatening the very existence of these companies, a fact, the dimensions of which are obscured by lax accounting rules); Ellen Joan Pollock & Jonathan M. Moses, Insurers Backed on Supplemental Coverage, WAIL ST. J. Feb. 14, 1992, at B2 (reporting that issue of whether supplementary insurers are liable for claims against bankrupt primary insurers is being litigated repeatedly "because of the recent spate of insurance company bankruptcies.").

There is also no guarantee that large claims will be paid by insurers without dispute over coverage and exclusions. See Milo Geyelin & William Power, Insurers Get Lift From Court in S & L Case, WALL ST. J., Sept. 24, 1991, at B5, reporting that recently, the FDIC sought to reach funds reserved in policies protecting directors and officers of a failed bank. The FDIC sought to assert its "public policy interest in recovering assets wherever possible," and asked that the clause in the insurance contract excluding coverage for "liability stemming from lawsuits by federal regulators" be voided. A federal court of appeals declined to do so, although "some lower courts have held that when private contractual rights of insurance companies conflict with strong public interest ... the public's interest prevailed." The insurance industry cited congressional intent that the exclusionary power of the insurers be recognized. In response, the FDIC, in a report to Congress, asked for "corrective legislation."' Id.

(n353) Interestingly, the original rationale for limited liability was somewhat different. In England, the grant of the corporate charter meant the creation of a separate person. The separate person theory was found useful to protect the assets of the corporation from being reached by the creditors of individual owners. To prevent this, corporate charters were redrafted by lawyers, which had the effect of creating, by contract, limited liability for the corporation's owners with respect to the corporation's obligations. By the end of the 17th century the limited liability of shareholders principle, at least with respect to trading companies, was embodied in English law. See MICHAEL B. METZGER ET AL., BUSINESS LAW AND THE REGULATORY ENVIRONMENT 898 (8th ed. 1992).

(n354) LIKIERMAN REPORT, supra note 99, at 27.

(n355) Id.

(n356) Epstein, supra note 300, at 1134.

(n357) Id.

(n358) Id. at 1135.

(n359) Id.

(n360) In general, exculpatory language is closely scrutinized, especially where a duty to the public is recognized. Jones v. Dressel, 623 P.2d 370 (solo. 1981); Milligan v. Big Valley Corp., 754 P.2d 1063 (Wy. 1988).

(n361) See Goldberg, supra note 225, at 302: "The accounting firm, in effect, engages in activities that enhance the value of its brand name and then rents the brand name to clients. Clients use this brand name as one element of a strategy to induce third parties to enter into financial transactions with them on favorable terms."

(n362) See 1 AICPA PROFESSIONAL STANDARDS, U.S. Auditing Standards, Statement on Auditing Standards No. 58 Section AU 508.08 (Am. Inst. of Certified Pub. Accountants (CCH) 1990) (setting out the approved language CPAs may use when issuing an unqualified audit opinion).

(n363) See, e.g., the various provisions built into the Uniform Commercial Code defining the scope of disclaimers and limitations of remedy affecting implied and express warranties; U.C.C. Sub section 5 2-316, 2-317, 2-719 (1976).

(n364) LIKlERMAN REPORT, supra note 99, at 21. It is uncertain whether the relevant statute would apply to liability to third parties. But at one point the report states, "In practice [the auditor] probably cannot limit any liabilities to other readers of the accounts, which for all limited companies are a public document...." Id. at 34.

(n365) Id. at 8.

(n366) Id.

(n367) Id. at 8, 21-22.

(n368) See supra note 225.

(n369) Id. at 308.

(n370) Id. at 301.

(n371) Id.

(n372) Id. at 305.

(n372) Id. at 305.

(n373) Id. at 304.

(n374) See supra notes 71-88 and accompanying text; infra notes 395-402 and accompanying text.

[n375] See generally, e.g., E. Haavi Morreim, Cost Containment and the Standard of Medical Care, 75 CAT. L. REV. 1719, 1740-42 (1987); Kenneth Vinson, Constitutional Stumbling Blocks to Legislative Tort Reform, 15 FLA. ST. U. L. REV. 31 (1987); Randall R. Bovbjerg et al., Public Policy: Valuing Life and Limb In Tort: Scheduling "Pain and Suffering", 83 Nw. U. L. REV. 908 (1989); Daryl L. Jones, Note, Fein v. Permanente Medical Group: The Supreme Court Uncaps the Constitutionality of Statutory Limitations on Medical Malpractice Recoveries, 40 U. MIAMI L. REV. 1075 (1986); Todd M. Kossow, Note, Fein v. Permanente Medical Group: Future Trends in Damage Limitation Adjudication, 80 Nw. U. L. REV. 1643 (1987); Manzer, surpa note 202.

[n376] See, e.g., Arneson v. Olson, 270 N.W.2d 125, 136 (N.D. 1978) (holding that North Dakota's statute limiting total recovery for medical malpractice to $300,000 violated the state and federal constitution's equal protection clauses.); Johnson v. St. Vincent Hosp. Inc., 404 N.E.2d 585 (Inc. 1980) (upholding $500,000 total recovery provision of the Indiana Malpractice Act in the face of constitutional challenges under due process, access to courts, equal protection, privileges and immunities, and trial by jury provisions of the Indiana and federal constitutions); Lucas v. United States, 757 S.W.2d (Text 1988) (holding that Texas statute limiting total medical malpractice awards to $500,000 violated the open courts provision of the Texas constitution).

(n377) See Manzer, supra note 202, at 637-38 and nn..57, 61 & 62 (citing statutes from Alaska, Michigan, and Washington).

(n378) Id.

(n379) CAT. CIV. CODE, Section 3333.2 (West Supp. 1986). Put See MINN. STAT. Section 549.23 (1988) (defining "intangible loss" to mean "embarrassment, emotional distress, and loss of consortium," but not "pain, disability, or disfigurement").

(n380) See Lucas v. United States, 757 S.W.2d 687, 689 (Text 1988) (noting that at least "thirteen states other than Texas have enacted damage limitation provisions into their medical malpractice statutes" and citing 10 eases challenging those statutes).

(n381) See, e.g., Wright v. Central DuPage Hosp. Ass'n, 347 N.E.2d 736 (Ill. 1976) ($500,000 cap constituted "special law" in violation of Illinois Constitution); Johnson v. St. Vincent Hosp., 404 N.E.2d 585 ($500,000 cap does not constitute a special privilege or immunity).

(n382) E.g., Carson v. Maurer, 424 A.2d 825, 837 (N.H. 1980) (equal protection violation: "It is simply unfair and unreasonable to impose the burden of supporting the medical care industry solely upon those persons who are most severely injured and therefore in need of compensation."); Arneson v. Olson, 270 N.W.2d 125 (N.D. 1978).

(n383) See, e.g., Fein v. Permanente Medical Group, 211 Cal. Rptr. 368 (Cal. 1985) ($250,000 does not violate California's due process guarantees); Morris v. Savoy, 581 N.E.2d 529 (Ohio 1991) ($200,000 limit on general damages violated state's due process guarantees).

(n384) See, e.g., Johnson v. St. Vincent Hosp., Inc., 404 N.E.2d 585 (Inc. 1980) ($500,000 cap does not violate right to remedy provision of Indiana constitution); Samsel v. Wheeler Transp. Serv., Inc., 789 P.2d 541 (Kan. 1990) (cap statute provides sufficient quid pro quo to satisfy right to remedy provision of Kansas constitution).

(n385) See, e.g., Smith v. Department of Ins., 507 So. 2d 1080, (Fla. 1987) ($450,000 cap violates Florida's open court provision). Lucas v. United States, 757 S.W.2d 687 (Tex 1988) (cap statute violates open courts provision of Texas constitution).

(n386) See, e.g., Moore v. Mobile Infirmary Assoc., No. 89-1087, 1991 Ala. LEXIS 1001 (Ala. Sept. 27, 1991) (cap statute violates right to jury trial guarantee); Etheridge v. Medical Center Hosp., 376 S.E.2d 525 (Va. 1989) (statute limiting total recovery to $750,000 does not violate right to jury trial).

(n387) Moore v. Mobile Infirmary Assoc., No. 89-1087, 1991 Ala. LEXIS 1001 (Ala. Sept. 27, 1991), at 4.

(n388) It is possible to provide for an outer cutoff cap without limiting any one plaintiff's damages. This appears to be what the European Economic Community did when it promulgated its Products Liability Directive in 1985. The Directive provided for a 70 million European Currency Unit (ECU) cap on a seller's total liability for injuries caused by a single product line. See Sara F. Leibman, The European Communities' Products Liability Directive: Is the American Experience Applicable?, 18 L. & POL'Y INT'L BUS. 795, 806-08 (1986). The unanswered question is what happens when the fund is exhausted. The result can be first come, first served or, alternatively, the plaintiffs' claims can be consolidated and the funds rationed. See also Price-Anderson Act, 42 U.S.C. Section 2210 (1982) (imposing a $560 million cap on any company's liability in the event of a nuclear accident).

(n389) Crooked S&L operators walked away with hundreds of millions of dollars or flitted away hundreds of millions of dollars of taxpayers' money, and the only ones in these joint and several actions who have any money to pay at the end of the day are the ones who benefited the least.' says Ralph C. Ferrara, a former Securities and Exchange Commission lawyer....

Sherry R. Sontag, Soured Deals Snag More Professionals, NAT'L L.J., Feb. 4, 1991, at 1. Cf. Paul M. Barrett, Court to Decide Outsiders' RICO Liability, WALL ST. J., Feb. 25, 1992, at B5 (reporting that Supreme Court will review 8th Circuit's ruling that accountants found to have committed securities fraud are not liable under RICO because firm's conduct "'didn't rise to the level of participation in the management or operation' of the cooperative"). Although this holding applies only to RICO liability, the court did distinguish between defendants responsible for managing an enterprise from those who merely provide professional services to it.

(n390) This argument is the basis of many challenges of cap statutes on equal protection grounds. In a medical malpractice context victims suffering severe injury argue that the cap discriminates against them in favor of those less severely injured. See Moore v. Mobile Infirmary Assoc., NO. 89-1087, 1991 Ala. LEXIS 1001 (Ala. Sept. 27, 1991), at 17; Carson v. Maurer, 424 A.2d 825, 837 (N.H. 1980). But see infra note 394 and accompanying text.

(n391) See LIKIERMAN REPORT, supra note 99, at 29.

(n392) Id. The proposed statute called for a minimum statutory cap of A$200,000 and when the audit fee becomes in excess of A$1m, the cap maximum is the greater of A$20m or ten times the fee.

(n393) Id. Various details such as the length of required PII periods, deductibles, holding company clients, and liability of principals and employees "who were not knowingly concerned" with willful conduct are also discussed.

The Likierman steering committee concluded that "none of the study teams believe it is appropriate at this stage.... [W]ithin each profession [auditing, surveying, construction] there are wide variations between the fee paid and the damage which can be caused by negligence." Id. at 7.

(n394) The fact that the victim of auditor negligence can anticipate ex ante the exposure to harm she faces distinguishes this case from medical malpractice under which victims have no similar ex ante options.

(n395) See supra notes 72-91 and accompanying text.

(n396) This is Robert Chatov's suggestion, supra note 89 and accompanying text.

(n397) It might be argued that it would advance efficiency to permit governmental discretion to match individual auditors with specific enterprises. We are more comfortable relying on the luck of the draw to make these matches, once an accounting firm is deemed qualified to handle a predetermined class of enterprises.

(n398) See supra notes 114-17 and accompanying text.

(n399) See supra respectively notes 97-98, 130-31 and accompanying text.

(n400) Sometimes internal pressures for accounting-consulting separation occur within large accounting firms. A case in point is reported in Management Brief: Civil War at Arthur Andersen, THE ECONOMIST, Aug. 1991, at 66. Although the management consulting business at Arthur Andersen grew much faster than accounting in the

1980s, internal power and compensation formulas continued to favor partners in the traditional accounting eve business. After several internal battles the consulting partners forced the firm to split into two units "each with its own strategy, mission statement, and almost complete financial autonomy." One surprising result of the split was a resurgence of accounting revenue growth in the face of heavy recessional forces. The article suggests that "removing the camouflage of consulting's good performance" created an incentive for the accounting partners to "improve their own performance." Does Andersen consulting still need the marketing synergy of the accounting division? The article states "the answer may well be `no'. Andersen's consulting business would lose little clout in its market by cutting its ties to the accounting business."

(n401) Examples of such a practice can be found in the advertising and public relations industries. While a client would rarely hire an advertising firm for advertising services if the firm were representing a competitor, it might hire the firm's public relations division if it were confident of that division's independence.

(n402) In 1976, the FASB set out to develop a conceptual framework for accounting, with one of its purposes being "[t]o prescribe future practice." Paul W. B. Miller, The Conceptual Framework: Myths and Realities, J. ACCT., March 1985, at 62. Specifically, the conceptual framework would function as a guide to the FASB by "narrow[ing] the range of alternatives to be considered by the board" which should lead to greater consistency within the set of emerging accounting principles and standards. David Solomons, The FASB's Conceptual Framework: An Evaluation, J. ACCT. June 1986, at 114. The French embarked on a similar process, by statute, in 1947. See supra notes 100-108 and accompanying text.

(n403) In an unprecedented initiative, the "big six" CPA firms have bonded together with other professional organizations to lobby "in favor of federal legislation to curb abusive lawsuits alleging securities fraud." High on the list of targeted reforms is abrogation of joint and several liability under the federal securities laws. If successful, this effort would certainly have considerable influence on state legislatures to enact similar laws. See Big Six Accounting ... WALL ST. J., Sept. 1, 1992, at B2.