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ISSUE BRIEF

Caveat Auditor: The Rise of Accountants' Liability

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Legal ReformOther

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The revolution in liability law started with personal-injury claims, and many observers have imagined, or hoped, that it would remain confined to that uniquely emotional class of cases. Not so. According to a survey by the publication *Inside Litigation*, quoted in the May 18 *Wall Street Journal*, the biggest judgments are now coming in the type of contract and business cases where the complained-of injuries are financial. Among the professions sore beset by lawsuits at the moment is one that puts out a wholly intangible "product": accounting.

Damage claims now pending against accountants have been estimated at between one and four billion dollars—a sum that could exceed the net capital of all accounting firms put together. Add in future claims over the S & L debacle, and the clouds grow darker still. Some of these suits are aimed at the profession's shadier members and ethical edge-skaters and thus might not worry the average practitioner. But most of the defendants are reputable mainstream firms. The Big Eight have been hit hard, as have the nation's 30,000 small and medium-sized firms, and the sense is growing that accounting, like obstetrics, neurosurgery and playground design, is becoming the kind of field where no one is safe from being sued.

The litigation onslaught led directly to an insurance crisis: premiums went up five-fold for the biggest firms from 1984 to 1987, and the number of insurers writing malpractice coverage for smaller firms fell from twelve in 1980 to three in 1986 before rebounding. In a survey of Wisconsin firms (cited as "recent" in the September 1987 *Journal of Accountancy*), one-fifth reported that they no longer had any coverage. Recently conditions have eased and coverage has become more widely available, but it is anyone's guess how long this will last: at some point the insurance cycle is bound to turn back from a buyer's to a sellers market.

Most often an accounting firm is sued when one of its clients goes broke. By that point the linedup creditors at the bankruptcy court are like the customers at a Soviet meat store; even for those at the front of the line, the pickings are slim. Any individual officers who mismanaged or looted the company are likely to be off the scene or assetless. What the creditors' attorneys look for is a solvent defendant, and the one who increasingly fits the bill is the firm that certified the company's financial statements—whether that firm was complicit in actual fraud of some kind by the departed management, or merely (as is more common) failed to detect the company's problems.

Leaving aside the S & L debacle for a moment, financial fiascos do not appear to be much more prevalent today than at various times in the past. Yet (again, even aside from S & Ls) the number of suits keeps rising. Unless auditors as a group have become several orders of magnitude more careless or corrupt lately, something must have happened on the legal scene. Actually, two somethings have happened: the first is the erosion in key states of old constraints on the right of third parties to sue accountants for negligence; the second is the RICO law.

Accountants have never enjoyed any sort of across-the-board legal immunity. They have always been open to suits from their clients if they fail to come up to promised professional snuff. Federal and state securities laws have also given outside investors certain rights to sue. But both these sources of liability are relatively tightly drawn, holding auditors liable for negligence (as opposed to fraud) only in fairly narrow circumstances. Until recently, the profession had little trouble coping with the resulting exposure.

In 1931 New York's highest court declared in the landmark case *of Ultramares Corp. v. Touche, Niven & Co*. that third parties such as creditors and investors who relied on financial statements could sue auditors for negligence only if the third parties were (in effect) intended beneficiaries of the contract between the firm and its auditor. To permit more, wrote then-Judge Benjamin Cardozo, would be to create "a liability in an indeterminate amount for an indeterminate time to an indeterminate class." This strict rule was loosened somewhat over the next half century, but only so far as to permit suds by third parties who the accountants specifically knew would be receiving and relying on the certified financial statements.

Then in 1983 came a thunderbolt: the New Jersey Supreme Court ruled (*H. Rosenblum, Inc. v. Adler*) that a negligent auditor is liable to any *reasonably foreseeable* person who properly obtains and relies on his or her work product —which essentially means the entire universe of creditors and investors, present and future, actual and potential. Several other states, including

Wisconsin and California, soon followed with even broader rules (the New Jersey court left hope that accountants might limit their liability by restricting the distribution of their work product; no such luck in Wisconsin or California). Thus, auditors sued under those states' laws now face exactly the sort of incalculably wide and unfathornably deep liability of which Judge Cardozo warned in *Ultramares*.

The other development is the discovery by plaintiffs' lawyers of the private-suit provisions of the Racketeer Influenced and Corrupt Organizations Act of 1970. Under civil RICO, legitimate businesses increasingly find themselves accused of "racketeering" in ordinary commercial disputes, and consequently face the prospect of triple damages (plus attorney's fees). Playing the RICO game is easy: any halfway competent lawyer can draft a complaint alleging the requisite "pattern" of wire fraud, mail fraud, or securities fraud by an auditor. Whether serious or patently silly, a RICO claim can have substantial settlement value when filed against a company that relies heavily on its reputational capital. (Drexel Burnham Lambert paid $650 million rather than face trial on federal RICO charges, and accountants are believed to be more tender of their reputations than investment bankers.)

If a suit shows even a remote prospect of a massive damage award, another factor comes into play: since accounting firms are partnerships, the members may each be jointly and severally liable for the full amount, and judgments can come out of their personal assets (assuming insurance has run dry). All in all, according to a *Wall Street Journal* report last year, RICO has become so attractive in lawsuits against accountants that it is "often invoked in ‘frivolous' claims because some attorneys believe that failing to invoke it could subject them to malpractice charges."

The Regulation of Optimism

The courts that invite the new kinds of common-law suits, and the academics who egg them on—along with the various advocates of wide RICO coverage—all advance much the same arguments: whatever their role in an earlier day, accountants are now public watchdogs and should be kicked regularly when they fail to bark; the threat of triple/unbounded liability is needed to make them properly careful; anyway, they can always spread the risk by buying malpractice insurance.

It is no accident that these are much the same "enterprise liability" arguments that have been deployed to justify the new productliability law. Dubious from the start, they are especially shaky when extended to accountants. Start with cost-spreading. As Professors Victor Goldberg and Thomas Gossman have both

demonstrated in recent articles (Victor Goldberg, "Accountable Accountants: Is ThirdParty Liability Necessary?", *Journal of Legal Studies*, June 1988; Thomas L. Gossman, "The Fallacy of Expanding Accountants' Liability", *Columbia Business Law Review*, No. 1 (11988), p. 213), accountants are among the worst conceivable candidates for the role of risk-spreader. Lenders and investors can typically predict to the penny how much they will lose if they guess wrong on an investment that goes sour. The more predictable the size of the loss, the more easily it is hedged; even small investors can keep their eggs spread among many baskets by investing in mutual funds or other diversified assets. Accountants and their insurers, on the other hand, cannot predict the extent of their open-ended exposure to an unknown, undefined and unlimited plaintiff class; to make matters worse, accountants are thinly capitalized.

Draconian liability rules no doubt make accountants more careful in some way. But in a good way? They penalize and thus discourage two distinct failings: first, inaccuracy or incompleteness; and second, overoptimism (since erring in a pessimistic direction will not lead to this sort of liability).

Accuracy and completeness, like all good things, come at a cost. The more extensive an audit, the more expensive, and there is always room at the margin to sample more of a given category of transactions, verify documents in a more elaborate way, and so forth. Cad Liggio, general counsel of Arthur Young & Co., is quoted in the January 24 *Wall Street Journal* as saying that audits so intense as to catch "all" fraud (in practice, a larger share of it) would cost perhaps four to six times as much as today's audits, which can run several thousand dollars apiece and are thus a major expense for small companies in particular. Because auditors cannot know in advance which will be the problem areas or clients, they will have to sell everyone the fuller audit. No advocate of stringent auditor liability has attempted to show that the gains would be worth it.

Then there's the question of overoptimism. Many believe that accountants are biased toward taking a sunny view of the financial condition of the companies who pay their fees. The new legal scheme handles this putative bias by adding an overlay of random terror that discourages all optimism, sincere or not. But errors of conservatism are just as much a distortion of the market as errors of recklessness. To the extent that auditors begin systematically understating assets or profits, some creditors or investors will miss out on profitable opportunities to do business because they believe the numbers. Others who are less credulous will simply learn to ignore the constant cries of wolf, as many investors already do with the gloomy boilerplate of SEC prospectuses.

Indeed, if it really made sense for accountants to intensify their efforts in a major way, let alone serve as residual insurers against their clients' failure, it

would have happened before now. Creditors and investors, which are frequently huge institutions, could insist that corporate borrowers arrange for more extensive audits or even, by offering vastly higher fees, induce their auditors to provide third-party warranties against negligence. They do not, which suggests that they realize it wouldn't be worth the cost on average.

Behind the new liability theories is an often-unexamined premise: that the real task of the auditor is to serve not the client, who pays the fees, but the outside public. This is not merely a way of stating the truism that auditors should be independent of management; even on that traditional view, serving a client's longterm interests can mean refusing to go along with the wishes of its current management. The idea is instead that a separate and higher duty is owed to the third parties who use auditors' work product gratuitously (and then complain about it afterward when it is not all it might have been).

Where could people have gotten that notion? Well, it turns out that none other than the American Institute of Certified Public Accountants carries on at length in its ethical code about "the profession's responsibility to the public" and how it "has grown as the number of investors has grown, as the relationship between corporate managers and stockholders has become more important, and as government increasingly relies on accounting information." These highminded (though in fact debatable) sentiments come at a cost: they can be seen as a standing invitation for third parties to come sue the AICPA's members. That is exactly what has happened: courts and commentators have widely cited the passage in their justifications of liability.

Many a discontented diner, after an unsatisfactory restaurant meal, has longed for revenge on the idiot reviewer who puffed the offending establishment (make him pay for the meal!). Yet most of us accept a world in which reviewers lay only their credibility, and not their pocketbooks, on the line when they offer opinions. Until recently the accountant, much like the food critic, could assume that whatever his contractual obligations to those who paid for his work, complete strangers would at least understand that they used his opinions at their own risk. Now we hear less and less of voluntary agreement and more and more of legal imposition. Given the track record of the modern liability regime in the safety-related fields it has already conquered, the financial world should brace itself. Caveat auditor.