Submission to the Treasury Department's
Advisory Committee on the Auditing Profession

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Thank you for inviting me to appear before the Committee at its February 4, 2008 meeting in Los Angeles, and for the opportunity to submit this statement in advance of that meeting.

Background/Introduction

By way of background, I am co-managing partner of Bernstein Litowitz Berger & Grossmann LLP, a fifty lawyer firm with its principal offices in New York and San Diego. Our firm serves as securities litigation counsel for scores of institutional investors, large and small, public and private, with total invested assets approaching one trillion dollars. Our clients' beneficiaries include active and retired school teachers, policemen, firemen, and other public servants, as well as carpenters, iron workers and operating engineers. Many of our clients are active in bringing litigation when they believe they have been victimized by fraud in the capital markets; others are close observers of the markets and the litigation landscape. All are keenly interested in ensuring that the capital markets in which they invest their beneficiaries' money operate with integrity, and they view the role of auditors as crucial to fostering the trust and confidence that underpins our capital markets. Mindful of the special trust that rests with auditors – and of the unfortunate consequences that can occur when auditors do not do what we all count on them to do – I urge the Committee not to imperil the confidence of investors by recommending changes to the regulatory and litigation landscape that would diminish the incentives for auditors to fulfill their unique role in our capital markets.

To give the Committee some sense of my standing to comment on such matters, let me say briefly that I have been litigating cases involving auditors as both a defense attorney and, for the last nine years, as a plaintiffs' attorney. I have served as lead trial attorney for jury trials against auditors in cases arising from the largest non-profit bankruptcy in our country's history (the *Baptist Foundation of Arizona* trial against Arthur Andersen LLP in 2002) and the largest corporate bankruptcy in American history (the *WorldCom* trial against Andersen in 2005). I am currently prosecuting several securities class actions that include auditors as defendants: the *Refco* matter (Grant Thornton LLP); the *HealthSouth* matter (Ernst & Young LLP); and the recently settled *Delphi* matter (Deloitte & Touche LLP). In addition to auditors, each of these cases involves other market actors such as issuers, corporate officers and directors, investment banks and, in some cases, attorneys. I am also prosecuting a number of securities cases involving allegedly false financial statements in which auditors have not been named as defendants, including the *Omnicom, Converium,* and *Merck* matters.

Suffice it to say that much of my interaction with the auditing profession has involved unhappy circumstances for that profession, such as ignoring repeated warnings of whistle-blowers, turning a blind eye to questionable receivables that dwarf a company's annual income, or changing a call on the propriety of management's problematic accounting rather than lose a

lucrative consulting contract. And while I operate on the assumption that the vast majority of auditors seek to comply with their legal, ethical and professional applications, I have had a unique opportunity to see how various influences and incentives can adversely affect an auditor's work. I have also seen first-hand the turmoil and dislocation that often accompanies audit failure, from wiping out the retirement of thousands of Baptist investors in the *Baptist Foundation* matter to the collapse of Fortune 50 companies and the overnight evaporation of tens of billions of dollars of shareholder wealth.

The Question Presented

It is with this perspective that I address one of the questions the Committee is considering, namely, whether there ought to be a cap on auditor liability. I respectfully submit that the case for such a cap has not been made.

As discussed further below, proponents of a cap unfairly inflate the threat posed by investor litigation, ignoring the ample protections afforded auditors under current law, as well as an historical track record which demonstrates that, even in so-called "mega-cases," audit firms are nowhere near as imperiled as claimed. Interestingly, the energy expended to conjure the litigation boogeyman is not matched by any commensurate effort to ascertain the financial wherewithal of audit firms to sustain a large adverse judgment. Put simply, even if one were able to quantify a realistic litigation threat of significant size, the question that must be answered is "threat to what?" Until audit firms are more forthcoming with their finances, as well as their actual insurance capacity, a proposal to treat those firms more leniently than other players in the capital markets should not advance.

Perhaps as important as assessing the supposed "risk" of maintaining the *status quo* in the litigation landscape is ascertaining whether the promised "reward" or benefit of a cap on auditor liability is, on balance, a good thing or a bad thing. Ostensibly, a cap will help ensure that the number of accounting firms available to audit public companies is not further reduced. (While that is a good thing, it must be noted that it was only a few years ago that some of the same parties now advocating a cap as necessary to avoid further consolidation of the profession were vigorously pursuing the mergers that took us from the Big Eight to the Big Five.) As explained below, however, a cap would have other, less beneficial consequences as well, which can be summarized here as follows: If the cost to audit firms for a blown audit goes down, there will be more blown audits.

Assessment of the "Threat"

Some claim that the present legal framework governing auditor liability is akin to a ticking time bomb. For example, it has been suggested that a "mega class action" that could wipe out one of the Big Four or one of the second-tier firms may be just around the corner. But if the Committee looks past the rhetoric and examines the existing U.S. securities laws and the court decisions interpreting them, it will see that there are robust safeguards already affording auditors ample protection, and that the prospect of an "Armageddon" scenario is extremely remote.

In 1995, Congress enacted the Private Securities Litigation Reform Act ("PLSRA"). The act was passed, over President Clinton's veto, in response to intense lobbying by corporate interests and their professional advisors (including auditors) concerning perceived threats and abuses posed by private securities actions. The PSLRA contains a number of significant provisions that curtail litigation risks for defendants in private securities actions. Among other things, the PSLRA establishes the most stringent pleading standard in any field of civil litigation in the United States. Moreover, unless and until a federal court determines that a private plaintiff's complaint has met those very high standards, an automatic stay of discovery is in place. In other words, a private plaintiff cannot seek any information from defendants or third parties to support a securities claim until *after* a federal judge has ruled that the plaintiff has already made a strong and particularized showing that a defendant made a misleading statement or omission and, further, that the defendant did so with the requisite fraudulent state of mind, or scienter. The PSLRA also requires that a plaintiff prove at trial that a defendant's violation actually caused the loss of which the plaintiff complains. And one of the most significant developments brought about by the PSLRA was establishing a regime of proportionate fault in securities fraud cases that, as pertinent here, sharply limits the potential liability of auditors unless it can be proven that they knowingly, as opposed to recklessly, committed fraud in violation of the federal securities laws.[1]

Over the past dozen years, courts have applied the PSLRA to further constrain private plaintiffs' ability to recover their losses through securities actions. Significantly, the United States Supreme Court has issued three opinions within the past several years that impose additional obstacles for investor plaintiffs. In *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005), the Court mandated a standard for pleading economic loss that was tougher than that adopted by many lower courts, and thereby substantially reduced defendants' potential exposure to liability. In *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. ___, 127 S. Ct. 2499 (2007), the Court tightened the requirements for pleading a "strong inference" that a defendant acted with a wrongful state of mind, holding that the allegations in a complaint must paint a "cogent and compelling" portrait of scienter if a claim is to survive. And the latest example of this defendant-friendly trend is the recent opinion in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43, 552 U.S. ___ (Jan. 15, 2008), which limits the ability of investors to hold third-parties accountable for engaging in deceptive acts that they know will be used by a company to falsify its financial results. Each of these decisions further constrains investors' abilities to pursue private actions to recover for losses suffered as a result of financial fraud. The flip side of these limits, of course, is the reduction of a prospective defendant's potential exposure to possible liability for questionable conduct.

It is important, then, to understand the gauntlet that an investor must run if it is to get any meaningful recovery from an audit firm, let alone a recovery that imperils the existence of a firm.

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[1] A further modification to the federal securities laws, the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), significantly limits the ability of injured investors to bring claims in state court (where state laws are often more investor-friendly) and, even in litigation brought in federal court, generally inoculates defendants from state law claims.

Assuming that facts giving rise to a claim come to light before the statute of limitations has lapsed, there must be a scenario in which:

(a) an investor is able to draft a complaint that meets the PSLRA's heightened pleading standards, without the benefit of any discovery;

(b) the plaintiff's complaint details "cogent and compelling" evidence that the auditor acted with fraudulent intent;

(c) the plaintiff alleges, with precision, a causal connection between the auditor's alleged misconduct and the losses suffered by the plaintiff;

(d) a jury unanimously finds that the auditor participated to a significant degree in the fraud after its conduct is compared with the actions of any other participants, including the corporate officers who presumably orchestrated the underlying fraud; and

(e) all legal rulings favorable to the plaintiff throughout the litigation survive appeal.

It is my experience that these hurdles present significant "downward drivers" on the settlement value of cases brought against auditors, and indeed often militate against even naming auditors as defendants.[2] These challenges are particularly daunting when auditors can point to evidence – as they can in virtually every case – that management conspired to lie to them and perhaps even generated false documentation in an effort to deceive them. My personal experience debriefing jurors in the *Baptist Foundation* and *WorldCom* trials confirmed that jurors are sympathetic to such arguments.

The provisions of the PSLRA (and SLUSA) were intended to curb private securities litigation and weed out weak or frivolous cases, and the record shows that these laws have accomplished that goal. The rate of dismissals of these actions has nearly doubled since passage of the PSLRA in 1995. Between 1991 and 1995, just over 19% of private securities fraud cases were dismissed. This figure increased substantially between 2000 and 2004, when 38.2% of these cases were dismissed. And that does not account for the cases that are never filed by virtue of the PSLRA's deterrent value.[3]

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[2] To the extent auditors may be vulnerable to joint and several liability under the Securities Act of 1933, it should be noted that, by definition, such claims arise in the context of a public offering of securities, where there invariably are other substantial defendants from whom investors may seek redress, such as the underwriting investment banks.

[3] *See* "Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar," NERA Economic Consulting, Jan. 2007 at p. 4 (available at www.nera.com). Professor James D. Cox, a securities and corporate law professor at Duke University School of Law, studied 600 class action lawsuits during the decade following passage of the PSLRA and concluded that the statute made pursuing such claims more difficult and "abusive or malicious" filings were difficult to locate. *See* Stephen Labaton, "Businesses seek new protection on legal front," The New York Times, Oct. 29, 2006 (available at 2006 WLNR 18761145) at Note 75. One significant observer of trends in private securities actions opined that the reduction in filings might be traced to "improvements in corporate governance following high publicity filings and settlements such as Enron and WorldCom, along with the passage of the

More pertinent for this discussion, of course, is the fact that, in today's environment, auditors are rarely named as defendants in these actions. In a three-year period immediately before the PSLRA was enacted – April 1992 through April 1995 – auditors were named as defendants in 81 of 446 private securities class actions filed, for an average of 27 suits per year, or 18% of all private securities class actions.[4] As the reforms of the PSLRA and the concomitant jurisprudence took hold, that number dropped precipitously. Auditors were named as defendants in only five suits in 2005,[5] and only two cases in each of 2006 and 2007.[6] The number for 2007 is especially telling because approximately one out of every eleven companies with U.S.-listed securities – almost 1200 companies in all – filed financial restatements in 2007 to correct material accounting errors.[7] Further, an analysis of securities actions filed in 2006 and 2007 demonstrates a significant decline in the number of cases alleging GAAP violations, appearing to suggest "a movement away from the focus in recent years on the validity of financial results and accounting treatment."[8]

Analysis of settlement payments by audit firms as a result of the cases filed during the recent "corporate crime wave" further confirms that claims of catastrophic liability exposure are exaggerated. Despite several multi-billion dollar scandals involving false financial statements of client companies, audit firms avoided suffering any serious blow, let alone any catastrophic threat. Our survey of settlements indicates that, if audit firms paid at all, it was typically a fraction of what other market actors paid. (A statement we frequently hear in settlement discussions is that Big Four firms will not pay a settlement that is more than 10% of what the issuer audit client paid.)

The conclusion that "litigation risk" to audit firms does not warrant further weakening of private rights of recovery is also supported by a comprehensive Government Accounting Office study released earlier this year, entitled "Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action."[9] In that

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Sarbanes Oxley Act of 2002." *See* "Securities Class Action Case Filings – 2005: A Year in Review," Cornerstone Research, 2006, at 2 (available online at: http://securities.stanford.edu/clearinghouse_research/2005_YIR/2006010301.pdf.).

[4] *See* Ross D. Fuerman, *The Role of Auditor Culpability in Naming Auditor Defendants in United States Securities Class Actions*, 10 CRITICAL PERSPECTIVES ON ACCOUNTING 315, 326-28 (1999) (available online at: http://www.idealibrary.com). Notwithstanding the substantial number of auditors named as defendants in his pre-PSLRA sample, Prof. Fureman concluded that non-culpable auditors typically were *not* named as defendants in his sample. *Id.* at 332-33.

[5] "Securities Class Action Case Filings – 2005: A Year in Review," Cornerstone Research, at p. 17.

[6] "Securities Class Action Case Filings – 2007: A Year in Review," Cornerstone Research, Jan. 2008, at p. 21 (available online at: http://securities.stanford.edu/clearinghouse_research/2007_YIR/20080103-01.pdf.).

[7] *See* Mark Grothe, "The Tide Is Turning," Glass, Lewis & Co., Jan. 15, 2008

[8] Cornerstone Research, *supra* note 6, at 20.

[9] U.S. General Accounting Office, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*, GAO-08-0163 (Washington, D.C., January 9, 2008).

report, the GAO considered various proposals from auditing firms and others to cap or otherwise limit auditor liability in private civil actions,[10] but ultimately concluded that "no compelling need for immediate action appears to exist."[11]

Another, less obvious aspect of existing law that protects auditors is the PSLRA's presumption that large institutional investors are best suited to serve as "lead plaintiffs" in securities class actions.[12] Because of this presumption, highly sophisticated investors are almost always front and center in the largest and most prominent securities class actions. According to a report issued by Institutional Investor Services in December 2006, fourteen of the fifteen largest securities class action settlements in history were led by institutional lead plaintiffs.[13] From these observations flow at least two significant propositions. First, in any future "mega-case" with multi-billions of dollars in damages, the lead plaintiff will almost certainly be a market-savvy institutional investor with experienced class counsel. Second, it is extremely unlikely that such an institutional lead plaintiff would insist on a settlement (or enforce a judgment) that would result in the failure of another audit firm. Would an institutional lead plaintiff seek a significant, even painful, recovery from an audit firm if the evidence so warrants? Yes. But given the sophistication and experience of these institutions, the breadth of their investments and participation in the U.S. capital markets, and the fact that many of the largest institutions serving as lead plaintiffs are, in fact, government pension funds, my experience suggests that none of these institutions would ever pursue a litigation strategy designed to destroy or even cripple an audit firm or any other defendant entity.[14]

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[10] *See, e.g ,id.* at 55-58.

[11] *Id.*, Summary of Findings.

[12] It was a principal goal of the PSLRA to create a meaningful opportunity for large institutional investors to serve as lead plaintiffs for these cases and, with those significant stakeholders at the helm, to increase oversight of the plaintiffs' attorneys and maximize recoveries in meritorious cases. By all measures that goal has also been achieved.

[13] In May 2007, a settlement was reached in the securities class action against Tyco International, Inc. for $3 billion, which would qualify as a "top 5" settlement. There, the class also was represented by institutional investors (public pension funds) serving as lead plaintiffs. *See* "Funds Net $3 Billion in Tyco Settlement," Pensions & Investments Newspaper, May 15, 2007 (available online at http://www.pionline.com/apps/pbcs.dll/article?AID=/20070515/DAILY/70515026).

[14] Interestingly, one of the studies promoting a cap on auditor liability – the so-called "McKinsey Report" commissioned by New York Mayor Michael Bloomberg and New York Senator Charles Schumer – mistakenly blames securities-related litigation for the demise of one of the Big Five, Arthur Andersen. *See* McKinsey Report at 76. The McKinsey Report is wrong. Arthur Andersen was not "forced into bankruptcy or liquidated" because of the threat of securities litigation. *Id*. Rather, Andersen collapsed because the U.S. Department of Justice indicted it for obstruction of justice in connection with the Enron debacle. Indeed, in direct contravention to the premise of the McKinsey Report, when Andersen was days away from a potential multi-billion dollar jury verdict in the largest securities case ever to go to trial – the *WorldCom* trial in 2005 – I saw first-hand how the institutional lead plaintiff there, the New York State Common Retirement Fund, settled that case in a way to ensure that that already-crippled firm did *not* have to file for bankruptcy. The McKinsey Report also blames the demise of WorldCom on the threat of securities litigation, by the way. *See* McKinsey Report at 76. That too is wrong; WorldCom filed for

"The Threat to What?"

The failure to assess reasonably the supposed litigation risk to audit firms is coupled with another material defect in the case for a cap on auditor liability: the absence of any meaningful exposition of the financial wherewithal of these firms to pay a potentially large verdict. Notwithstanding their plea to be treated more leniently than other market actors, audit firms do not publicly disclose their financial status like issuers or investment banks, and it is not possible to assess whether the claim of vulnerability to "catastrophic liability" has merit.

What is discernable about the revenues of the Big Four – principally from examining what their clients report as audit fee expenses in SEC filings – suggests that the finances of the Big Four are quite robust. Audit fees paid to these firms have increased significantly each year since the passage of Sarbanes-Oxley in 2002; reported audit fees for S&P 500 companies alone totaled $2.22 billion in 2003, $3.51 billion in 2004, and $3.79 billion in 2005.[15] The dramatic increase in money paid to auditors to do their jobs after the passage of SOX is decidedly ironic, given that SOX was passed on the heels of corporate scandals which, in my view, were possible only because too many auditors were *not* doing their jobs in the 1990s.

Another important piece of any analysis of an audit firm's financial vulnerability is an assessment of available insurance. Here, too, the essential facts remained obscured. Audit firms have not been sufficiently forthcoming on matters such as the amount of coverage from classic insurance underwriters or their efforts to self-insure. As for the latter, audit firms appear reluctant to explain why more of the cash they chose to distribute to partners year-in and year-out cannot be set aside in reserve for the litigation charge they seem so assured is coming.

In making a plea for special treatment based on what they claim is financial peril, it is incumbent on the audit firms to be forthcoming about their true financial capacity to withstand a "mega judgment." They have not to date, and appear unwilling to do so in future. That alone should end the discussion.

Adverse Consequences of a Cap on Auditor Liability

The concept of a cap on auditor liability is not only insupportable based on what we know (the true litigation landscape) and what the audit firms will not reveal (their actual financial situation), it is also decidedly a bad idea. Put bluntly, the question presented to the Committee is "should accountants be held less accountable?" The answer is self-evident. Artificially limiting auditor liability would reduce auditor accountability, reduce audit quality, and ultimately harm the capital markets as investor confidence in the accuracy and transparency of financial statements is called into question.

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bankruptcy weeks several weeks after its bombshell announcement of a $3.2 billion restatement on June 25, 2002, well before the lead plaintiff in the securities litigation had even been appointed.

[15] *See* Glass Lewis & Co., LLC.; *Duke – ILEP Conference on Reform Proposals of Committee on Capital Market Regulation and U.S. Chamber of Commerce*, Durham, North Carolina (February 2, 2007) citing S&P 500 Company Filings.

This is not rhetoric. It is in fact an apt description of what happened just a few years ago, the last time the audit profession got comfortable with the idea that its litigation exposure was circumscribed. That view was, unfortunately, one of the apparent "takeaways" from enactment of the PSLRA – that with the heightened pleading standards, discovery stay, proportionate fault, and other obstacles to investor redress in place, accounting firms could take more chances and cut corners on audit staffing, become more pliable to management, and render the concept of "professional skepticism" hollow. The results can be summed up in a few words: WorldCom, Enron, HealthSouth, Tyco, Cendant, Rite Aid, Adelphia, AIG, and Parmalat, to mention just a few. These massive accounting frauds – which led market watchers to ask plaintively – "where are the auditors" – caused enormous harm to our financial markets and the country as a whole. While it may not be possible to say with certainty that the PSLRA's insulation of auditors from liability was the sole cause of these accounting catastrophes, it would be wrong to dismiss the correlation as a mere coincidence. Indeed, based on what I have seen in my cases, there is compelling evidence that removing, or at least seriously weakening, the threat of litigation contributed significantly to the poor audits that were done in the late 1990s, and the abdication of the auditor's traditional role as an independent watchdog. Significantly, after Congress passed Sarbanes-Oxley and several of the Big Four firms paid nine-figure settlements to resolve some of the scandals alluded to above, auditors realized again that they could be held liable for their conduct and the number of accounting frauds has dropped markedly. This recent history offers a lesson too painful to be learned a second time.

Reducing Auditor Exposure through Revival of Scheme Liability

I do believe there is one change to the securities litigation landscape that, if adopted, would further reduce the liability exposure of audit firms in future corporate scandals and, at the same time, offer defrauded investors a fairer opportunity to recoup losses caused by corporate wrongdoers. The change would be to revive scheme liability, and enable investors to seek redress not just from auditors who were reckless in failing to uncover a company's fraud, but also from third-parties who knowingly participated in deceptive conduct intended to deceive the investing public about a company's finances, and in many instances the audit firm as well.

As noted above, in its recent *Stoneridge* decision, the Supreme Court held that the Section 10(b) private right of action does not permit investors to sue suppliers and customers who had allegedly created false invoices designed to allow a company to mislead its auditors and falsify its financial results. Many in the defense bar and corporate lobby have extolled this decision as the death of scheme liability as a viable legal theory. I disagree that the decision is that airtight – its logical underpinnings certainly are not – but I concede that the decision has made the world considerably safer for those who profit from engaging in deceptive conduct that enables a company to report false financial results. Ironically, the decision has made the world *less* safe for auditors, in at least two ways.

First, given the proportionate liability paradigm of the PSLRA, the auditor now has fewer other faces at the defense table with whom to share blame. The Supreme Court has essentially immunized third parties who engage in deceptive conduct – even for lying to auditors – and thereby eliminated them from consideration as fraudsters who might be assigned a percentage of responsibility on the jury verdict form. Who among those left is to share the percentage(s) that

would otherwise go to those bad actors? The audit firm that was reckless in not discovering that it was the victim of their deceptive conduct.

Second, by immunizing those who are smart enough to keep out of public sight the lies they tell to auditors, the *Stoneridge* decision makes it likely that more lies will be told to auditors in the future. This will not make the auditor's job any easier. I am currently involved in several cases where significant profit was made by third parties who knew their conduct would expose them to the possibility of a securities fraud judgment but who nonetheless decided it was worth the risk to engage in sham transactions. Query how similarly motivated third parties will act in the future when, thanks to *Stoneridge*, the risk of such liability is essentially zero.

To be clear, I am not advocating the revival of "aiding and abetting" liability or the reversal of the seminal Supreme Court decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). I am advocating the repudiation of the *Stoneridge* decision, and the flawed logic that tellingly declined to analyze the difference in the facts between the "aider and abettor" in *Central Bank* (who had no idea that fraud was afoot) and the false-invoice makers in *Stoneridge* (who did). How would I propose to define the difference between a scheme participant and one who merely aids and abets? A workable distinction does exist, namely, that the schemer must itself perform some dishonest or deceptive act – fabricating invoices or preparing legal paperwork for round-trip loans intended to hide receivables at year-end, for example – and know (or be reckless in not knowing) that its deceptive conduct would result in false information entering the securities markets.[16]

While it may seem counter-intuitive to propose expanding the private right of action in order to address auditor concerns about securities litigation, the logic for doing so is sound. Reviving scheme liability for third parties who would deceive auditors would deter those who would lie to auditors. And it also would ensure that those who do lie to auditors absorb their fair share of the blame from a seat alongside the auditor at the defense table. Audit firms should welcome each of these developments, which unlike a cap on auditor liability and the problematic consequences that would flow from it, would further reduce the liability exposure of auditors at the same time it enhanced the integrity of the capital markets.

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Thank you for considering the foregoing. I look forward to discussing these and any other matters of interest to the Committee in Los Angeles on February 4.

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[16] With all due respect, the Supreme Court's argument that the requirement of committing a deceptive act does not adequately distinguish a participant in a fraudulent scheme from an aider and abettor is a *non sequitur*. That requirement for proof of a deceptive act in other circumstances is what distinguishes securities fraud from innocent conduct.