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Articles

PROPORTIONALITY: A MUCH-NEEDED SOLUTION TO THE ACCOUNTANTS' LEGAL LIABILITY CRISIS*

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I. INTRODUCTION

A fundamental precept of American jurisprudence is the apportionment of liability based on fault, with culpable parties paying their fair share of damages. As logical and fair as that proposition appears, it is increasingly the exception rather than the rule in some areas of litigation, particularly federal securities fraud litigation against certified public accountants. Achieving equitable outcomes by relating the degree of liability to the proportion of damages or settlements paid is nearly impossible in most such cases. By mandating joint and several liability, federal securities laws and some state laws encourage suits against "deep pocket" defendants, such as accounting firms, for the sole purpose of extracting settlements from those parties, regardless of their actual responsibility, if any, for the losses suffered. In this respect, the current system

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reinforces and rewards the filing of lawsuits based on the ability to pay rather than on the level of culpability.

Existing data show large numbers of such suits and nearly limitless financial exposure for accounting firms. Indeed, unwarranted securities fraud litigation is now so significant that it threatens the continued viability of the audit function. Major accounting firms face massive litigation exposure. The cost of defending meritless cases, of which there are many, is inordinately high. Far from being commonplace commercial disputes between two parties, shareholder class actions are among the largest cases in the federal judicial system. These "facts of life" have inexorably led major accounting firms to develop stringent risk management programs that focus on vulnerability to litigation, not on the ability to audit successfully. Consequently, promising but high-risk companies—whose products and services our nation must bring to market to remain globally competitive—are, and will increasingly be, deprived of valuable professional expertise.

Accounting firms are not the only victims of the present shareholder class action system and the runaway joint and several liability that lies at its core. The current system fails fairly to compensate investors, large and small, who are the victims of real fraud and who recover only a few cents on the dollar. It also discourages managements from disclosing the very type of information that is essential for intelligent investor decisions. Indeed, these lawsuits create incentives to withhold information—precisely the opposite effect of what the securities laws were meant to accomplish in public policy. Finally, joint and several liability disproportionately affects high-tech and growth companies, thereby diverting resources that would otherwise fuel innovation and job creation.

We believe that a rule of proportionate liability would go a long way toward rectifying these serious and growing problems. Proportionality can break the magnetic attraction of class action lawyers to deep pocket defendants, regardless of the merits of the underlying case. Reforming joint and several liability would help relieve much of the nonmerit-based pressure to settle these abusive cases. Because the amount of recovery from each defendant would be limited by the degree of the defendant's culpability, the merits of the claim would matter more to plaintiffs' lawyers than the depths of the defendant's pocket. Furthermore, proportionate liability would encourage lawyers to seek greater compensation for those who are truly defrauded, by changing incentives for attorneys from filing and settling as many cases as possible, without regard to merit, to obtaining more money for investors whose cases have real merit.

This Article begins by tracing the history of the concept of “fair share” liability.¹ We focus first on the development of comparative fault, which has replaced contributory negligence as the law of the land in forty-six of the fifty states, and then we summarize the historical background of joint and several liability, the results of a more liberal interpretation of that doctrine, and the response of state legislatures and courts to that interpretation through adoption of various forms of proportionate liability. Against this historical backdrop, this Article then addresses the problem of joint and several liability in accountants’ malpractice claims, particularly in shareholder class actions under the federal securities laws. The reasons why it is unreasonable and unfair to make auditors the “deep pocket” defendant are discussed,² as are the consequences of this trend for the audit function.³ The negative consequences of these lawsuits on investors, high-tech and growth companies, and the overall securities system are also discussed.⁴ We conclude by proposing the adoption of proportionate liability as the new standard to replace joint and several liability in all cases that do not involve intentional fraud.⁵

II. EROSION OF THE CONCEPT OF “FAIR SHARE LIABILITY”

Embedded in the foundation of this nation’s jurisprudence is the concept of apportioning liability based on fault. Indeed, far from being a new or radical idea, it is an outgrowth of the notion of “comparative fault,” which has replaced “contributory negligence” as the law of the land in forty-six of the fifty states. The historical development of contributory negligence, and its subsequent virtual abandonment in favor of a system based on degree of fault, reflect changes in judicial and societal views of the role of the tort system in effectively compensating victims and deterring wrongdoers. Unfortunately, however, this concept of “fair share liability” was then eroded by widespread application of “joint and several liability” against defendants. While a majority of states have since limited this concept in different ways and to different degrees, joint and several liability remains a serious problem at both the state and federal level.

A. Contributory Negligence

The doctrine of “contributory negligence” was first adopted in the United States in the early nineteenth century, when a Massachusetts court held that an action could not be maintained unless the plaintiff could show that he had used

1. See *infra* text accompanying notes 6-53.
 2. See *infra* text accompanying notes 54-81.
 3. See *infra* text accompanying notes 82-116.
 4. See *infra* text accompanying notes 117-57.
 5. See *infra* text accompanying notes 158-67.

“ordinary care” to protect himself.⁶ Under this doctrine, even though both parties are at fault, liability falls wholly on the plaintiff, regardless of whether his negligence made a substantial or material contribution to his injury.⁷ The primary rationale for this harsh doctrine was that the plaintiff’s negligence supersedes the defendant’s actions as the proximate cause of the injury suffered.⁸ It was considered beneficial to society to penalize the plaintiff for his misconduct and to deter him from injuring himself.⁹ Moreover, as a general policy, common law courts routinely held that a wrongdoer should not be entitled to seek relief from the courts.¹⁰

Since juries could not find for an injured plaintiff unless they determined him to be blameless, they often stretched, or at least appeared to stretch, the law to fit their own view of an equitable result. Faced with an all-or-nothing choice with respect to recovery for the plaintiff, juries sought to take it upon themselves to do justice where a defendant did share some responsibility for the loss.

As dissatisfaction with the all-or-nothing system grew, it eventually led to the adoption of several exemptions. For example, contributory negligence did not serve as a bar to the plaintiff’s recovery where the defendant’s conduct was intentional; where the defendant had the “last clear chance” to exercise ordinary care and avoid the plaintiff’s injury; or where the plaintiff’s negligence was remote. Despite these exemptions, the burden of loss was still placed upon one person where two were, in effect, responsible. As a result, contributory negligence continued to preclude the equitable allocation of damages between plaintiff and defendant.

B. Comparative Negligence

In 1908, Congress adopted the first federal comparative negligence statute, which was designed to rectify the often unjust outcome of suits brought by

6. *Smith v. Smith*, 19 Mass. 621, 624 (1824). The common law doctrine of contributory negligence is traced to Lord Ellenborough’s opinion in *Butterfield v. Forrester*, 11 East 60, 103 Eng. Rep. 926 (1909). The court held that the plaintiff could recover for his injuries if the defendant breached a legal duty owed to the plaintiff, and if the plaintiff, in spite of the defendant’s conduct, exhibited “no want of ordinary care” in avoiding harm to himself. In other words, the plaintiff must not have contributed to his own injury. *Id.*

7. W. PAGE KEETON ET AL., *PROSSER & KEETON ON THE LAW OF TORTS* § 65, at 451-52 (5th ed. 1984) [hereinafter *PROSSER & KEETON*].

8. *Id.* at 452.

9. Prepositions used in the masculine are intended to include the feminine, and vice versa.

10. John W. Wade, *Should Joint and Several Liability of Multiple Tortfeasors Be Abolished?*, 10 AM. J. TRIAL ADVOC. 193, 196 (1986).

injured railway employees.¹¹ Under this “pure” comparative negligence statute, a plaintiff could recover damages from the negligent railroad regardless of the extent of his own negligence; those damages were merely reduced by the percentage of fault attributable to the plaintiff’s own actions. Following this federal lead, numerous states adopted statutes providing specific relief to railroad employees.¹²

By the early 1970s and 1980s, a flood of legislative and judicial activity brought relatively comprehensive adoption of comparative fault by the states.¹³ The threshold issue for most jurisdictions was whether to adopt a “pure” or “modified” comparative negligence system. Those opting for the modified version had to determine what degree of fault should preclude a plaintiff’s recovery. Most jurisdictions chose between allowing the plaintiff to be as negligent, but no more negligent, than the defendant (the 50% Rule), or allowing the plaintiff to recover only if he is actually less negligent than the

11. See 45 U.S.C. §§ 51-60. Prior to the adoption of the federal statute, the concept of comparative negligence was recognized in the U.K. and the U.S., even as the doctrine of contributory negligence was developing. The equity courts had long recognized comparative negligence as an integral part of admiralty law. HENRY WOODS, *COMPARATIVE FAULT* § 1:4, at 18 (1987). In fact, Dean Prosser noted that, by 1953, the U.S. was virtually the last country with a modern judicial system, whether common or civil law based, to apply contributory negligence as a general standard. Great Britain, Canada, New Zealand, and most of Europe were apportioning damages. This is due, in part, to the fact that comparative negligence was much more readily accepted in other legal systems where trial by judge was more common than trial by jury. See Jordan H. Leibman & Anne S. Kelly, *Accountants' Liability to Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle*, 30 AM. BUS. L. J. 345, 376 (Nov. 1992). A judicial fact finder was thought to be more capable of apportioning damage than a lay jury.

12. In 1910, Mississippi became the first state to adopt a pure comparative negligence statute for all personal injury actions and, by 1920, the statute was expanded to include damages to property. MISS. CODE ANN. § 11-7-15 (1972). In 1913, the Georgia Supreme Court adopted a comparative negligence system that permitted a plaintiff to recover so long as his degree of negligence was less than that of the defendant. *Elk Cotton Mills v. Grant*, 79 S.E. 836 (Ga. 1913). While this was the precursor to “modified comparative fault” statutes, the idea attracted little interest beyond the legal community until the early 1930s, when Wisconsin adopted a general comparative negligence statute mandating that a plaintiff could recover only if his negligence was “not as great as the negligence of the person against whom recovery is sought.” WIS. STAT. ANN. § 895.045 (1989-90). See WOODS, *supra* note 11, at 25.

13. Leibman & Kelly, *supra* note 11, at 376-77 n.155. Only four states and the District of Columbia have not adopted comparative negligence. Twelve states—Alaska, California, Florida, Kentucky, Louisiana, Michigan, Mississippi, Missouri, New Mexico, New York, Rhode Island, and Washington—have adopted pure comparative negligence as their standard. ALASKA STAT. § 09.17.060 (Supp. 1993); CAL. CIV. CODE §§ 1431, 1431.2 (Supp. 1994); FLA. STAT. ANN. § 768.81 (West Supp. 1993); KY. REV. STAT. ANN. § 411.182 (1991); LA. CIV. CODE ANN. art. 2323 (West Supp. 1993); MICH. COMP. LAWS ANN. § 600.6304 (1987); MISS. CODE ANN. § 11-7-15 (1972); MO. REV. STAT. § 537.067 (1988); N.M. STAT. ANN. § 41-3A-1 (Michie 1989); N.Y. CIV. PRAC. L. & R. 1411 (McKinney 1976); R.I. GEN. LAWS § 9-20-4 (1985); WASH. REV. CODE ANN. § 4.22.070 (1988).

defendant (the 49% Rule). In all, ten states have adopted the Modified 49% Rule,¹⁴ and twenty-three states have adopted the Modified 50% Rule.¹⁵

In sum, an overwhelming majority of the states have jettisoned the all-or-nothing contributory negligence approach, choosing instead to apportion liability more fairly between plaintiff and defendant pursuant to the doctrine of comparative negligence. This, of course, raises the issue of why the same principles of equity should not apply to apportioning liability among multiple defendants or joint tortfeasors. We turn next to that question.

C. Origins of "Joint and Several" Liability

The doctrine of joint and several liability initially developed as two separate theories of liability. At common law, joint liability was strictly limited, applying only to joint tortfeasors acting in concert or in conspiracy.¹⁶ Under this narrow interpretation of the doctrine, if the parties did not act in concert, joinder, and hence joint liability, were not permitted. Since concert of action and a common plan usually characterize actions involving a higher degree of intent or scienter, true joint liability was originally an issue only in cases involving intentional torts.¹⁷

14. Modified 49% Rule states: Arkansas, Colorado, Idaho, Kansas, Maine, North Dakota, Tennessee, Utah, and West Virginia. ARK. CODE ANN. § 16-64-122 (Supp. 1993); COLO. REV. STAT. § 13-21-111.5(1) (1989); IDAHO CODE § 6-801 (1990); KAN. STAT. ANN. § 60-258a (Supp. 1992); ME. REV. STAT. ANN. tit. 14, § 156 (1980); N.D. CENT. CODE § 32-03.2-02 (Supp. 1993); TENN. CODE ANN. § 29-11-103 (1980); UTAH CODE ANN. § 78-27-38 (1992); W. VA. CODE § 55-7B-9 (Supp. 1993). South Dakota has chosen a system that ignores the 49/50 distinction and applies joint and several liability where the plaintiff's negligence is "slight." S.D. CODIFIED LAWS ANN. § 20-9-2 (1987).

15. Modified 50% Rule states: Connecticut, Delaware, Georgia, Hawaii, Illinois, Indiana, Iowa, Massachusetts, Minnesota, Montana, Nebraska, Nevada, New Hampshire, New Jersey, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Texas, Vermont, Wisconsin, and Wyoming. CONN. GEN. STAT. ANN. § 52-572(h) (West 1991); DEL. CODE ANN. tit. 10, § 8132 (Supp. 1992); GA. CODE ANN. § 51-12-33 (Supp. 1993); HAW. REV. STAT. § 663-31 (1985); ILL. ANN. STAT. ch. 735, para. 5/2-1116 (Smith-Hurd 1992); IND. CODE ANN. § 34-4-33-3 (West Supp. 1993); IOWA CODE ANN. § 668.3 (1987); MASS. GEN. LAWS ANN. ch. 231, § 85 (West 1986); MINN. STAT. ANN. § 604.01 (West 1998 & Supp. 1994); MONT. CODE ANN. § 27-1-702 (1993); NEB. REV. STAT. § 25-21, 185.10 (Supp. 1992); NEV. REV. STAT. § 41.141 (Supp. 1993); N.H. REV. STAT. ANN. § 507:7-d (Supp. 1992); N.J. STAT. ANN. §§ 2A:15.5.1-5.3 (West 1987 & Supp. 1993); OHIO REV. CODE ANN. § 2315.19 (Anderson 1991); OKLA. STAT. ANN. tit. 23, §§ 13, 14 (West 1987); OR. REV. STAT. § 18.470 (1988); 42 PA. CONS. STAT. ANN. § 7102 (1982 & Supp. 1993); S.C. CODE ANN. § 15-38-30 (Supp. 1993); TEX. CIV. PRAC. & REM. CODE ANN. §§ 33.001 - .017 (1986 & Supp. 1994); VT. STAT. ANN. tit. 12, § 1036 (Supp. 1993); WIS. STAT. ANN. § 895.045 (1983); WYO. STAT. § 1-1-109 (1988).

16. PROSSER & KEETON, *supra* note 7, at 323. At common law, a joint tort required a concert of action, a common plan, or, later on, a breach of a joint duty.

17. *Smithson v. Garth*, 3 Lev. 324, 83 Eng. Rep. 711 (1691).

If a plaintiff was injured as a result of the acts of two or more tortfeasors *not* acting in concert, he could sue any or all of them individually and recover his full damages, but he could not join all parties in one suit.¹⁸ Furthermore, if he recovered his damages from one defendant, he could not seek recovery from any of the others. As a result, deep pocket defendants became quite popular at this early stage of the doctrine's development. When filing his first claim, a shrewd plaintiff would want to seek out the defendant best able to pay. If he could recover all of his damages at that stage, he would not need to proceed further. From a procedural standpoint, the efficiency and economies associated with holding a single trial were lost. Moreover, recovery could be obtained from any individual defendant without regard to that defendant's actual degree of fault.

As application of the doctrine widened, courts adopted a rule that permitted a plaintiff to join two defendants together in one action where two separate negligent acts produced a single indivisible harm.¹⁹ Since the jury was still not considered capable of apportioning damages among the defendants, the judgment against each would be for the full amount of damages. The plaintiff was permitted to recover from the defendants in any way that he found expeditious, and the defendants still had no legal right of contribution among themselves. Thus, as the practice of joining defendants who acted separately but created one indivisible injury grew common, the concept of joint *and* several liability became an integral part of the tort system.²⁰

These changes in apportionment still reflected the continuing application of contributory negligence. If the plaintiff could recover at all (i.e., was not at fault or had a suitable defense), the question then became how much damage the defendants collectively should pay, not the individual defendant's degree of fault. Eventually, the adoption of comparative negligence by the majority of states led to the adoption of "comparative contribution,"²¹ pursuant to which the fact

18. Wade, *supra* note 10, at 194.

19. *Id.*

20. Courts also developed a parallel theory of "alternative liability" to address situations where one of two or more defendants individually caused the injury to the plaintiff, but where the defendant causing the injury cannot be satisfactorily identified. This is the textbook case of *Summers v. Tice*, 199 P.2d 1 (Cal. 1948), where two hunters aimed carelessly and shot in the direction of the plaintiff. At trial, the plaintiff could not say with certainty which of the defendants had caused his injury. The court held both defendants liable and did not require the plaintiff to identify the defendant actually at fault. Under these circumstances, each defendant must prove that he did not proximately cause the plaintiff's injury or be liable jointly and severally with his codefendant(s). This theory of alternative liability was adopted primarily because public policy dictated that the plaintiff should not be without a remedy where the harm was clear, but the cause was ambiguous. This shifting of the burden of proof was eventually adopted by the *Restatement*. *RESTATEMENT (SECOND) OF TORTS* § 433(B)(3) (1965).

21. Wade, *supra* note 10, at 197.

finder must determine the percentage of fault of each of the parties to the action and establish an amount for which each is primarily responsible. Each defendant remained liable for the full amount of damage to the plaintiff, however, and could still be held liable for that full amount regardless of the percentage of fault assigned.²²

D. Results of More Liberal Interpretation of Joint and Several Liability

As a matter of policy, several justifications—occasionally conflicting—have supported joint and several liability. These include the need to encourage socially desirable behaviors (such as caution and responsibility),²³ the need to compensate innocent plaintiffs; the desire to distribute losses among the parties; and, eventually, the desire to force the lion's share of damages onto those with the greatest ability to pay.²⁴

The need to punish those with any degree of fault was sufficient justification for imposing joint and several liability at common law. As the doctrine was expanded to apply to non-intentional torts, however, culpability alone was not sufficient. A popular alternative rationale then developed that highlighted the need to compensate innocent plaintiffs. This rationale was appealing so long as the plaintiff was truly blameless; after the adoption of comparative negligence, it lost some force, because now the plaintiff was often not wholly innocent. Eventually, many believed that it would be beneficial to distribute losses throughout society via insurance companies or other types of social insurance programs. This rationale was particularly appealing in product liability cases, where multiple insured parties had introduced a product and all had benefitted financially from sales of the defective item.²⁵

Recently, the trend has been to shift loss onto those best able to pay—"deep pocket" defendants. As a result, plaintiffs now often sue the party or parties with the deepest pockets, instead of those who are most responsible for a loss.

22. A majority of individual states have modified in different ways and to different degrees the application of joint and several liability. See *infra* notes 29-53 and accompanying text.

23. Michael Schofield, *Davies v. Mann: Theory of Contributory Negligence*, 3 HARV. L. REV. 263, 269 (1890).

24. James J. Scheske, *The Reform of Joint and Several Liability Theory: A Survey of State Approaches*, 54 J. AIR LAW & COM. 627, 631 (1988).

25. This notion is even supported in the language of the Uniform Comparative Fault Act drafted by the National Conference of Commissioners on Uniform State Laws. UNIF. COMPARATIVE FAULT ACT § 3 (1977, as amended 1979), 12 U.L.A. 53 (Supp. 1993). "[I]n attaining a fair application to a particular factual situation, consideration needs to be given to the circumstances of whether each party is able to pay his obligation and whether the payment comes from his own pocket or from liability insurance covering him." *Id.* at 45. This concept had a tremendous impact on the disposition of automobile accident cases, and subsequently on the cost and availability of insurance.

Indeed, although juries commonly find that a deep pocket defendant's liability is slight, the doctrine of joint and several liability subjects those defendants to liability for the full amount of damages. One court, for example, held Walt Disney World liable for eighty-six percent of a \$75,000 judgment, even though, at trial, they were found to be only one percent at fault.²⁶ This lends support to the notion that deep pocket defendants are often sued primarily because other, far more culpable defendants are judgment-proof or have inadequate funds.

These developments were not without high social costs. For example, municipalities are now often sued as deep pockets in cases where their passive roles are said to have caused an accident. The city of Los Angeles, for instance, was left to pay almost \$2 million in damages to a plaintiff hit in a city intersection, even though the defendant driver was intoxicated at the time he ran the stop sign and struck the plaintiff. Because the driver had no money and the other co-defendants settled for the amount of their insurance policies, the city had to pay the bulk of the damages.²⁷ Under these circumstances, it is no wonder that local governments today cite joint and several liability as a reason for higher taxes and reductions in public services such as playgrounds and pools. But beyond the municipal sphere, there are much broader implications for society. For example, corporations are no longer willing to take risks even with vital products, because the burden of potential liability is too great.²⁸

26. *Walt Disney World Co. v. Wood*, 515 So. 2d 198 (Fla. 1987). The plaintiff was found to be 14% at fault in a bumper car accident, while her fiancé was found 85% at fault and Disney 1%. The fiancé was a non-contributing defendant and, as such, the trial court assigned Disney the full 86% of damages.

27. The plaintiff argued that the city should have put up signs to warn of the upcoming stop sign and should have trimmed hedges located on private property that partially blocked the stop sign. *Sills v. City of Los Angeles*, C-333504 (San Fernando Super. Ct. Mar. 14, 1985). In another case, a drunk driver collided with another vehicle coming in the opposite direction as he crossed the center line on a curve. The city of San Diego was joined based on a claim that the accident was the result of a faulty road design. The driver settled for \$25,000 (the amount of his insurance policy) and the city settled for \$1.6 million after the initial court proceedings. *Duggan v. City of San Diego*, No. 484152 (San Diego Super. Ct. Mar. 1, 1984). In yet another case, a motorcycle collided with a car that turned in front of it. The motorcycle passenger was wearing a large belt buckle which injured the driver of the motorcycle when the passenger slid forward on impact and hit him in the back. The motorcycle driver sued, among others, Rayco, Inc., who had reupholstered the cycle's seat. The driver claimed that the fabric was stretched too tight, making it "excessively slippery." The driver of the automobile settled for \$25,000 (the amount of her insurance policy); the other defendants had little or no assets, and Rayco was held liable for the \$2.5 million in damages. *Laurenti v. Tiffenbauch*, No. A-6247-82 (N.J. Super. Ct. App. Div. Aug. 2, 1984).

28. For example, the University of Wisconsin admits that it hesitates to sell licenses for university patents to small businesses because of concerns that a suit against such companies may result in the university being sought out as a deep pocket by plaintiffs, based on its initial research of the idea. Union Carbide developed a portable kidney dialysis unit for home use. It subsequently sold the business to a foreign company after determining that the potential risks of litigation made the product uneconomical. Genentech, a leading U.S. biotechnology company, halted its AIDS vaccine research after the California legislature failed to enact state tort reform, and Bristol-Myers

E. Modification of Joint and Several Liability at the State Level

By and large, modifications to the applicability of joint and several liability at the state level either have been contemporaneous with the states' change to comparative fault or have reflected subsequent recognition of the inequitable outcomes when comparative fault and joint and several liability are applied concurrently. Tennessee, one of the most recent states to convert to comparative fault, noted in doing so that having "adopted a rule more closely linking liability and fault, it would be inconsistent to simultaneously retain a rule, joint and several liability, which may fortuitously impose a degree of liability that is out of all proportion to fault."²⁹ As Dean Prosser has said, "No one ever 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."³⁰

Significantly, thirty-seven states have altered their statutes, responding in some degree to the inequities of joint and several liability.³¹ These states have recognized that joint and several liability fails to serve the public interest because it encourages suits against defendants with deep pockets, regardless of their responsibility. They have sought to curb abuse of the litigation system by requiring that secondary wrongdoers pay only for the damage they cause.

Thus, eight states—Alaska, Kansas, Kentucky, Oklahoma, Tennessee, Utah, Vermont, and Wyoming—have eliminated joint and several liability entirely, concluding that defendants should at all times be liable in tort actions for their proportionate share of the harm. Roughly half of these states adopted reform in conjunction with an abandonment of contributory negligence. This suggests that states find it easier to justify proportionate liability, which insists that the plaintiff take his defendants as he finds them, when the plaintiff's prior

Squibb abandoned one promising research approach because of liability concerns. Studies have been cited that indicate "47% of U.S. manufacturers have withdrawn products from the market, [and] 39% have decided not to introduce new product lines . . . as a direct result of their product liability experience . . ." See HOUSE SUBCOMM. ON TECHNOLOGY AND COMPETITIVENESS, COMM. ON SCIENCE, SPACE AND TECHNOLOGY, REPORT ON PRODUCT LIABILITY, H.R. REP. NO. 167, 102d Cong., 2d Sess. 4 (Dec. 1992) (emphasis added).

29. *McIntyre v. Balentine*, 833 S.W.2d 52, 58 (Tenn. 1992) (emphasis added). Also note that even though Massachusetts courts have, to date, declined to change the state's common law view that defendants are jointly and severally liable, they have noted recently that "the comparative negligence system has its merits in a case where one tortfeasor incurs minimal negligence and the other tortfeasors are insolvent, enjoy limited liability or are otherwise protected by operation of law, or in instances where the plaintiff incurs substantial contributory negligence." *Joia v. Jo-Ja Service Corp.*, 817 F.2d 908, 917 (1st Cir. 1987), cert. denied, 484 U.S. 1008 (1988).

30. *Leibman & Kelly*, *supra* note 11, at 376 n.154 (quoting PROSSER & KEETON, *supra* note 7).

31. Stated differently, only 13 states and the District of Columbia still retain the concept of joint and several liability at all times and for all cases.

alternative was no recovery at all unless he was blameless.

Six more states have adopted proportionate liability while specifically excluding cases involving intentional torts and/or strict liability.³² New Mexico, for example, maintains joint and several liability for intentional torts, for cases based on strict liability, and in other situations with a "sound basis in public policy."³³ This implicitly recognizes that joint and several liability is essentially punitive, because it forces a defendant to pay more than his fair share of damages. For cases that involve a higher degree of culpability (a "knowing" action), payment of all damages, even if punitive, is seen as acceptable.

The most common exceptions to proportionate liability in those states which have partially retained the joint and several rule are for "large-scale" torts. Consequently, in certain mass injury situations, compensation to the victim is deemed to hold the highest priority. For instance, some jurisdictions retain joint and several liability for cases relating to toxic torts and hazardous waste disposal.³⁴ Others maintain joint and several liability for automobile and airline accidents³⁵ or for product liability cases.³⁶ Idaho retains joint and several liability for cases involving pharmaceutical manufacturers or medical device manufacturers, since defective drugs or faulty medical devices may cause large-scale injury.

32. Florida, Hawaii, Nevada, New Mexico, New York, and North Dakota. FLA. STAT. ANN. § 768.81 (3) (West Supp. 1993); HAW. REV. STAT. § 663-10.9 (Supp. 1992); NEV. REV. STAT. ANN. § 41.141 (Supp. 1993); N.M. STAT. ANN. § 41-3A-1 (Michie 1989); N.Y. CIV. PRAC. L. & R. 1601, 1602 (McKinney Supp. 1994); N.D. CENT. CODE § 32-03.2-02 (Supp. 1993). Under New York law, joint and several liability applies to certain product liability suits, knowing or intentional acts, acts in concert, and hazardous waste cases. N.Y. CIV. PRAC. L. & R. 1602 (McKinney Supp. 1994).

33. Recently, this was held to include cases in which precautions were not taken against inherent dangers. *Saiz v. Belen Sch. Dist.*, 827 P.2d 102 (N.M. 1992).

34. Arizona, Florida, Hawaii, Idaho, Nevada, New York, Oregon, Texas, and Washington. ARIZ. REV. STAT. ANN. § 12-2506 (Supp. 1993); FLA. STAT. ANN. § 768.81 (West Supp. 1992); HAW. REV. STAT. § 663-10.9 (Supp. 1992); IDAHO CODE § 6-803 (1990); NEV. REV. STAT. § 41.141(5)(c) (Supp. 1993); N.Y. CIV. PRAC. L. & R. 1602 (McKinney Supp. 1994); OR. REV. STAT. § 18.485 (1988); TEX. CIV. PRAC. & REM. CODE ANN. § 33.012 (1986 & Supp. 1994); WASH. REV. CODE ANN. § 4.22.070(3)(a) (1988).

35. Hawaii and New York. HAW. REV. STAT. § 663-10.9 (Supp. 1992); N.Y. CIV. PRAC. L. & R. 1602 (McKinney Supp. 1994).

36. Hawaii, Nevada (strict liability cases and defective product cases), New Mexico (strict liability), New York, North Dakota, and Washington (generic product cases). HAW. REV. STAT. § 663-10.9 (E) (Supp. 1992); NEV. REV. STAT. § 41.141 (5) (Supp. 1993); N.M. STAT. ANN. § 41-3A-1(C)(3) (Michie 1989); N.Y. CIV. PRAC. L. & R. 1602 (10) (McKinney Supp. 1994); N.E. CENT. CODE § 32-03.2-02 (Supp. 1993); WASH. REV. CODE ANN. § 4.22.070(3)(c) (1988).

While not necessarily set forth in specific terms in the statute, the policy rationale for preserving joint and several liability in these large-scale injury cases appears to be the need to compensate victims who have suffered *personal injuries* as a result of some mass disaster, and to punish the perpetrator of such a disaster who, through a single act or product, caused widespread harm. Compensation and deterrence are needed most when injury or death results from water that has been poisoned, from hazardous waste that has been dumped, or from a defective aircraft that has crashed.

Several states have adopted proportionate liability where the defendant's culpability falls below some fixed percentage.³⁷ This reflects a policy choice not to impose the full burden of liability upon a tangentially liable defendant.³⁸

Four states consider the plaintiff's degree of fault, if any, by applying proportionate liability if the plaintiff bears some degree of fault.³⁹ The remaining fourteen states look to the defendant's degree of liability, sometimes providing a specific percentage below which a defendant will be held liable only for its proportionate share,⁴⁰ and sometimes requiring that the defendant's fault

37. Some states look to the fault of the plaintiff, *see infra* note 39, and others to the fault of the defendant(s), *see infra* note 40, either in relation to each other and/or in relation to the plaintiff, *see infra* note 41.

38. Florida provides for proportionate liability for damages in excess of \$25,000 (FLA. STAT. ANN. § 768.81 (West Supp. 1993)), and Mississippi holds defendants jointly liable only to the point where the plaintiff has recovered 50% of his damages (MISS. CODE ANN. § 11-7-15 (1972)). In addition to fashioning exceptions based on the characteristics of the case or the litigants, a few states have chosen to provide for reallocation of damages. This permits an insolvent or sometimes absent or immune defendant's share of damages to be reallocated among the remaining parties. States permitting reallocation of uncollectible damages: Connecticut (non-economic damages only), Michigan, Missouri, Montana (specifically notes that the reallocation includes defendants who are otherwise severally liable), and New Hampshire. CONN. GEN. STAT. ANN. § 52-572 (h) (West 1991); MICH. COMP. LAWS ANN. § 600.6304 (1987); MO. REV. STAT. § 537.067 (1988); MONT. CODE ANN. § 27-1-703 (1993); N.H. REV. STAT. ANN. § 507:7-d (Supp. 1992). Sometimes the reallocation includes the plaintiff and sometimes merely the other defendants. This is slightly less onerous than joint and several liability where there are multiple defendants; if the plaintiff is not included in the reallocation, and there is only one remaining solvent defendant, however, the result is precisely the same as if joint and several liability had been used in the first place.

39. Georgia, Michigan, Missouri, and Texas. GA. CODE ANN. § 51-12-33 (Supp. 1993); MICH. COMP. LAWS ANN. § 600.6304 (1987); MO. REV. STAT. § 537.067 (1988); TEX. CIV. PRAC. & REM. CODE ANN. § 33.013 (1986 & Supp. 1994).

40. States adopting this approach to proportionate liability include: Illinois (defendant is 25% or less liable, or has been assigned less fault than that attributed to the plaintiff and the other defendants individually), Indiana (defendant less than 50% at fault), Iowa (defendants less than 50% at fault), Minnesota (defendant less than 15% liable is limited to damages of four times his degree of fault), Montana (defendants less than 50% liable), New Hampshire (defendants less than 50% liable), New Jersey (defendant is less than 20% liable, several for non-economic damages if defendant is 20-60% liable, otherwise joint and several), New York (economic damages and defendant is less than 50% at fault), Oregon (for economic damages where defendant is less than

be less than the plaintiff's in order to qualify for proportionate liability.⁴¹

Some states mandate proportionate liability based on the type of damages awarded to the plaintiff. For example, nine states limit the applicability of joint and several liability by drawing a distinction between economic and non-economic damages.⁴² Of these, only California, Nebraska, and Ohio cite this as a sole distinction, granting proportionate liability to defendants only for non-economic damages.⁴³ The remaining states hold defendants jointly and severally liable for economic damages, or specifically permit defendants to be held proportionately liable for non-economic damages.⁴⁴ Hawaii and New York conditionally hold defendants jointly and severally liable for non-economic damages.⁴⁵

All of the reforms to joint and several liability previously discussed were based on legislative action. But several state courts have modified joint and several liability as well. In some of these states, the legislatures acted after the judicial decision by amending the relevant statute, while in others the judicial decision alone continues to apply.

15% at fault), South Dakota (defendants less than 50% at fault are limited to two times their percentage of liability), and Texas (defendant's fault is less than 20%). ILL. ANN. STAT. ch. 735, para 5/2-117 (Smith-Hurd 1992); IND. CODE ANN. § 34-4-33-5(b) (West Supp. 1993); IOWA CODE ANN. § 668.4 (1987); MINN. STAT. ANN. § 604.02 (West 1988 & Supp. 1994); MONT. CODE ANN. § 27-1-703 (1993); N.H. REV. STAT. ANN. § 507:7-3 (Supp. 1992); N.J. STAT. ANN. § 2A:15.5.3 (West 1987 & Supp. 1993); N.Y. CIV. PRAC. L. & R. 1601, 1602 (McKinney Supp. 1994); OR. REV. STAT. § 18.485 (1988); S.D. CODIFIED LAWS ANN. § 15-8-15.1 (Supp. 1993); TEX. CIV. PRAC. & REM. CODE ANN. § 33.013 (1986 & Supp. 1994).

41. Louisiana (proportionate if plaintiff's degree of fault is greater than defendant's), Missouri (if plaintiff's fault is greater than defendant's, defendant's damages are limited to twice his percentage of fault), Oregon (proportionate if defendant's fault is less than plaintiff's), and Texas (joint and several where defendant is more than 20% liable and his fault exceeds that of the plaintiff). LA. CIV. CODE ANN. art. 2324 (West Supp. 1993); MO. REV. STAT. § 537.067 (1988); OR. REV. STAT. § 18.485 (1988); TEX. CIV. PRAC. & REM. CODE ANN. § 33-013 (1986 & Supp. 1994).

42. See *infra* notes 43-45. "Non-economic damages" are subjectively determined losses including, but not limited to, damages for pain and suffering and emotional distress.

43. Ohio allows proportionate liability for non-economic damages only if the plaintiff is found at fault. OHIO REV. CODE ANN. § 2315.19 (Anderson 1991).

44. Connecticut, Florida (at the court's discretion if the defendant's fault is equal to or greater than the plaintiff's fault), Hawaii, Montana, New York, and Oregon (defendants severally liable for economic damages, too, if defendant less than 15% at fault). CONN. GEN. STAT. ANN. § 52-572(h) (West 1991); FLA. STAT. ANN. § 768.81(3) (West Supp. 1993); HAW. REV. STAT. § 663-10.9 (Supp. 1992); MONT. CODE ANN. § 27-1-703 (1993); N.Y. CIV. PRAC. L. & R. 1601, 1602 (McKinney Supp. 1994); OR. REV. STAT. § 18.485 (1988).

45. Hawaii (if the defendant is more than 25% at fault) and New York (if the defendant is more than 50% liable). HAW. REV. STAT. § 663-10.9 (Supp. 1992); N.Y. CIV. PRAC. L. & R. 1601, 1602 (McKinney Supp. 1994).

As previously discussed, for example, the Supreme Court of Tennessee abandoned the doctrine of joint and several liability at the same time that it adopted the doctrine of comparative fault. Drawing support from the decisions of other state courts on the issue, the court indicated that its conclusion was based on considerations of fairness to both plaintiffs and defendants.⁴⁶ Similarly, the Kansas Supreme Court, in construing the state's adoption of comparative fault by statute, noted that the legislature's purpose was clear: it "intended to equate recovery and duty to pay with degree of fault."⁴⁷ Accordingly, the court maintained that this necessitated a change in *both* the doctrine of contributory negligence and the doctrine of joint and several liability: "There is nothing inherently fair about a defendant who is ten percent at fault paying 100% of the loss, and there is no social policy that should compel defendants to pay more than their fair share of the loss. Plaintiffs now take the parties as they find them."⁴⁸

In *Hilen v. Hays*, the Kentucky Supreme Court adopted comparative fault, noting that "in a system in which liability is based upon fault, the extent of the fault should govern the extent of the liability."⁴⁹ In a later decision, the court ruled that, since a plaintiff who is only partially at fault cannot be required to bear the entire loss, it should follow logically that "a defendant who is only partially at fault in causing an injury should not be required to bear the entire loss but should, likewise, be chargeable only to the extent of his fault."⁵⁰ Using the same logic, the Oklahoma Supreme Court determined that "if a jury is capable of apportioning fault between a plaintiff and defendant, it should be no more difficult for it to allocate fault among several defendants."⁵¹ The court concluded that it would be "obviously inconsistent" with the equitable principles of comparative negligence to hold the defendant tortfeasor who is only twenty percent at fault responsible for the entire amount of damages.⁵²

* * * * *

Unfortunately, for those who operate nationwide, the state-by-state approach to change discussed in this Section is exceedingly slow and produces

46. See *McIntyre v. Balentine*, 833 S.W.2d 52, 58 (Tenn. 1992), discussed *supra* note 29 and accompanying text.

47. *Brown v. Keill*, 580 P.2d 867, 873-74 (Kan. 1978).

48. *Id.* at 874. See also *Bartlett v. New Mexico Welding Supply, Inc.*, 646 P.2d 579 (N.M. App. 1982).

49. *Hilen v. Hays*, 673 S.W.2d 713, 718 (Ky. 1984) (citation omitted).

50. *Prudential Life Ins. Co. v. Moody*, 696 S.W.2d 503, 505 (Ky. 1985).

51. *Laubach v. Morgan*, 588 P.2d 1071, 1075 (Okla. 1978).

52. *Id.*

a hodgepodge of complex rules. Moreover, plaintiffs' lawyers can easily "venue-shop," thereby avoiding states that have enacted effective reforms. Further, as noted by the drafters of the Model Comparative Fault Act, state laws "var[y] considerably, and the form adopted often comes about as a result of a political compromise and without adequate consideration of the practical implications."⁵³

As a result, the very positive changes in state law described above still leave serious problems for parties operating on a national basis and have not, of course, effected any change in federal law. For instance, because corporations and businesses now routinely deal with purchasers and clients across the country, plaintiffs can often justify bringing suit in any number of state jurisdictions; for obvious reasons, they choose the jurisdiction most advantageous to their claim. This problem is a particularly serious one for larger accounting firms, which are responsible for the vast majority of audits of publicly owned companies in this country.

III. THE PROBLEM OF JOINT AND SEVERAL LIABILITY IN ACCOUNTANTS' MALPRACTICE CLAIMS

As it has evolved over several centuries from its original rationale of ensuring that plaintiffs receive redress for physical injury, joint and several liability today is a blunt instrument indeed when applied to generally less threatening, more complex business situations involving economic losses and multiple actors. Under the joint and several liability system today, achieving equitable outcomes—relating the degree of responsibility to the proportion of damages paid—is nearly impossible in most cases. The system encourages suits against deep pocket defendants, who become virtual guarantors of the full extent of damages, regardless of how liability (theirs and others') is apportioned.

Accountants' malpractice claims, particularly in the context of federal securities fraud cases, illustrate the point well. With today's increasingly volatile markets reflecting an extremely fast-changing, competitive, global marketplace, stocks of many companies—particularly those in high-tech and growth industries—fluctuate widely. Life-cycles of new technologies and products shrink; breakthroughs appear more quickly; and foreign competition grows. In such an environment, downturns as well as upturns can be more frequent and widespread, particularly as equity investment has proliferated, with an impact on total market values measured in the tens and hundreds of millions of dollars.

53. UNIF. COMPARATIVE FAULT ACT, 12 U.L.A. 43 (Supp. 1993) (Prefatory Note).

There is no doubt that, in this complex marketplace, some malfeasance and even fraud occurs. In a few cases, an auditor may even have known about the fraud and participated in it. But existing rules of liability—particularly the availability of joint and several liability for unintentional conduct that may be characterized as “recklessness” under the federal securities laws—attract a far greater number of suits that do not involve any such misconduct. And the very complexity of the marketplace makes it impossible to predict how litigation about one event in it will be resolved.

The indeterminate character of “recklessness” makes auditors particularly vulnerable to frivolous suits, because an audit by nature involves considerable estimation and judgment exercised against materials prepared by others. Joint and several liability lures plaintiffs with the prospect of potentially huge deep pocket recoveries or settlements from accounting firms. Indeed, because joint and several liability threatens responsibility for 100% of the damages regardless of how minimal the auditor’s culpability, with twenty-twenty hindsight it demands near-perfection on the part of the auditor in performing a task that—because it involves estimation and judgment—by definition, cannot be “perfectly” accomplished. As a result, the future of the audit function is threatened, with grave consequences for the smooth functioning of our capital markets and economy as a whole.

A. *The Auditor’s Actual Role and Relationship to Management*

By definition, an audit is an independent opinion on the fairness with which the financial statements produced by company management present the company’s financial position and results of operations.⁵⁴ The auditor is not responsible for preparing those statements, which are merely a snapshot of the results of management’s stewardship at a given moment in time. Moreover, an auditor is clearly not responsible for the innumerable daily decisions of management that determine the ultimate success or failure of a company, let alone the short-term rise or fall of its stock.⁵⁵ As a majority of the California Supreme Court wrote in its 1992 *Bily* decision:

An auditor is a watchdog, not a bloodhound. As a matter of commercial reality, audits are performed in a client-controlled environment. The client typically prepares its own financial statements; it has direct control over and assumes primary responsibility for their contents . . . [and] necessarily furnishes the information base for the audit Thus, regardless of the efforts of the auditor, the

54. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, AU § 110.01 (1992).

55. *Id.* at AU § 110.02.

client retains effective primary control of the financial reporting process.⁵⁶

In order to form an audit opinion on financial statements, the auditor is guided by Generally Accepted Accounting Principles (GAAP). Because these principles are codified only in part, applicable governing rules must be derived. Furthermore, auditors sample and test a company's transactions selectively. This examination is based on Generally Accepted Accounting Standards (GAAS), which, like GAAP, are written in general terms and require considerable exercise of professional judgment by the auditor.⁵⁷

Thus, the California Supreme Court concluded in *Bily* that "an audit report is not a simple statement of verifiable fact that, like the weight of the load of beans . . . can be easily checked against uniform standards of indisputable accuracy. Rather, *an audit report is a professional opinion based on numerous and complex factors.*"⁵⁸ Insightfully, the *Bily* court added that the audit report is "the final product of a complex process involving discretion and judgment on the part of the auditor at every stage. Using different initial assumptions and approaches, different sampling techniques, and the wisdom of 20-20 hindsight, few CPA audits would be immune from criticism."⁵⁹

Auditing, then, is as much an art of judgment and experience as an axiomatic set of procedures. And audit fees are based not on the size of a stock offering or its degree of success, but purely on the actual audit performed. Indeed, auditors are prohibited from charging any kind of contingent fee based on an audit's outcome or effect in the marketplace.⁶⁰ This concept contrasts sharply with potential gains to be realized in initial public offerings by the company and other involved parties (and often tangential defendants) such as investment bankers, whose fees reflect outcomes as well as inputs.

56. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 762 (Cal. 1992) (citations omitted).

57. Robert Mednick, *The Auditor's Role in Society: A New Approach to Solving the Perception Gap*, J. ACCT., Feb. 1986, at 70-74.

58. *Bily*, 834 P.2d at 763 (emphasis added; citation omitted). The court added that "the auditor's role in the financial reporting process is secondary and the subject of complex professional judgment . . ." *Id.*

59. *Id.*

60. The Public Oversight Board, created in 1977 by the American Institute of Certified Public Accountants to oversee and report on the Peer Review Program for firms that audit publicly held entities, recently noted that the current liability system ignores—unfairly—the fact that "[the] monetary benefit which accrues to accountants is minuscule in relation to the liability which can be imposed if there is no reasonable limiting principle." AICPA PUBLIC OVERSIGHT BOARD, IN THE PUBLIC INTEREST 5 (1993) [hereinafter POB REPORT].

B. *The Indeterminate Nature of "Recklessness" as Applied to the Audit Function*

Under the federal securities laws, a plaintiff seeking damages under Section 10(b) of the Securities Exchange Act of 1934 must show that the defendant has used or employed "in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance . . ." ⁶¹ Furthermore, Rule 10b-5 of the Securities and Exchange Commission prohibits the use of "any device, scheme, or artifice to defraud," the making of material misrepresentations, or omitting to disclose material facts in certain circumstances, or any act that would "operate as a fraud or deceit" in the purchase or sale of a security. ⁶²

In *Ernst and Ernst v. Hochfelder*,⁶³ the United States Supreme Court addressed a long-standing question about the state of mind necessary to prove a violation of Section 10(b) and Rule 10b-5. Rejecting the contention that liability could be predicated on a defendant's negligence, the Court held that "*scienter*"—defined in a footnote as "a mental state embracing intent to deceive, manipulate or defraud"—was a necessary element of a claim. ⁶⁴

The Court in *Hochfelder* specifically reserved the question whether a reckless (versus merely negligent) misrepresentation or omission might satisfy this requirement of *scienter*.⁶⁵ Since then, however, most (but not all) courts of appeal have determined that recklessness is sufficient to invoke liability under Section 10(b) and Rule 10b-5. In theory, a standard of recklessness requires a high degree of culpability—certainly much higher than mere negligence. But, as noted by one commentator who has studied this issue in depth, the courts have been

less than precise in defining what exactly constitutes a reckless misrepresentation. *That imprecision has resulted in ad hoc, if not arbitrary, recklessness determinations.* One judge may deem an accused party to have acted recklessly, while a different judge in another case may exonerate a defendant charged with nearly identical misconduct. Over a decade of litigation has done precious little to clarify the ambiguities. The result is that actual and potential parties

61. 15 U.S.C. § 78j(b) (1988).

62. 17 C.F.R. 240.10b-5 (1990).

63. 425 U.S. 185 (1976).

64. *Id.* at 193 & n.12.

65. *Id.* On two occasions, the Supreme Court has since declined to decide whether recklessness satisfies the *scienter* requirement. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.4 (1983); *Aaron v. SEC*, 446 U.S. 680, 686 n.5 (1980).

to Section 10(b) and Rule 10b-5 actions cannot predict with any degree of certainty how a trier of fact will characterize challenged conduct and thus whether it may serve as the basis for liability. Nor can actors in securities transactions ensure that they take the steps necessary to minimize the potential for liability.⁶⁶

Thus, legal practice in securities fraud cases does not neatly follow legal theory. Once one moves beyond intentional fraud, which is relatively obvious,⁶⁷ a clear bright line of demarcation dissolves. As Jake Netterville, former Chairman of the American Institute of Certified Public Accountants (AICPA), writes: "There is no such sharp line separating an audit that failed to detect a fraudulent scheme because the accountant acted recklessly from an audit that failed to detect a fraud for a variety of other reasons."⁶⁸

The very nature of an audit, as discussed above, compounds this serious problem. For example, a jury presented with a case often confronts, with the benefit of hindsight, a business problem that has caused a decline in the value of a company's securities. Under these circumstances, every stage at which the auditor exercised independent professional judgment is scrutinized. Juries, most of whose members are unfamiliar with the subjectivity of financial statements and the complexities of the audit function, naturally find it difficult to understand why the auditor did not foresee the problem. It is easy to see how ordinary good-faith judgments might be improperly deemed reckless when the statements turn out to be "inaccurate." In this environment, trying to distinguish between innocent mistakes, negligence, even gross negligence—none of which is actionable under Rule 10b-5—and recklessness is extremely difficult.⁶⁹

66. Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV. 667, 674-75 (1991) (emphasis added). Professor Johnson adds, based on his extensive analysis of the issue, that the case law at times seems conclusory, if not largely incoherent. Reasoned and principled distinctions are few and far between. . . . At one end of the spectrum, two circuits apply the ominous sounding "severe" recklessness test. At the other end of the spectrum, at least one court and for a time a court of appeals, endorses a standard that seems little different from negligence. Between the extremes are a few opaque variations of so-called recklessness standards. . . . "About all that can be said with confidence is that 'the standard falls somewhere between intent and negligence.'"

Id. at 686-87, 695 (citations omitted).

67. Formulating a precise definition is a bit like seeking to define obscenity; while it is difficult to arrive at the exact words that are adequate, as the late Justice Potter Stewart put it, "I know it when I see it." *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).

68. Letter from Jake L. Netterville to Senator Christopher J. Dodd, 2-3 (Sept. 20, 1993) [hereinafter Netterville Letter] (on file with the *Valparaiso University Law Review*).

69. These problems are illustrated well in a recent enforcement action brought by the SEC against one accounting firm and described in Mr. Netterville's letter to Senator Dodd. In a case arising out of a 1982 bankruptcy of one of the firm's clients, the SEC alleged a violation of Rule 10b-5, asserting that the firm had acted recklessly in failing to comply with professional standards

Quite simply, a bright line cannot be consistently drawn. As A.A. Sommer, Jr., Chairman of the AICPA's independent Public Oversight Board, recently testified, the distinction between recklessness and negligence in securities fraud cases is honored more in the breach than in the observance. In his words:

Now it's a debatable question, the problem of recklessness versus negligence And that very confusion about the standards that are applicable in an appropriate case is indicative of why you have the problem with recklessness. Very often juries tend to view negligence as recklessness because the standard is a very elusive one⁷⁰

Thus, "although the term 'recklessness' sounds like it encompasses only extreme misconduct, recklessness is in practice an ill-defined label that can be—and often is—erroneously applied to conduct that complies fully with applicable professional standards or amounts to at most bare negligence."⁷¹

C. *The "Deep Pocket" Auditor: Limitless Financial Exposure*

As discussed above, the limits on recklessness that theoretically exist in the classroom do not prevail when juries apply them in the courtroom. There, a wide spectrum of conduct—some wrongful, some quite benign—is lumped together as reckless. Significant in its own right, this problem is wildly exacerbated because of the availability of joint and several liability. This rule encourages the filing of lawsuits based on conduct short of true recklessness merely to force settlements of those suits even when they are without merit.

The availability of joint and several liability has encouraged an explosion of litigation against accountants, who are, in fact, sometimes the only deep pockets left standing in the wake of a business failure. A decade ago, the

in auditing the company's 1980 financial statements. A federal district court rejected every claim against the accounting firm, including the claim that the firm had acted recklessly. Instead, the court found that the SEC's claims "involved complex issues of accounting as to which reasonable accountants could reach different conclusions It follows that no finding of fraud or recklessness can rationally be made in this case." SEC v. Price Waterhouse, 797 F. Supp. 1217, 1241 (S.D.N.Y. 1992). As Mr. Netterville put it: "If the SEC, with all of its experience, can so significantly misjudge an accountant's work, it is not surprising that juries of ordinary citizens can be—and are—confused in deciding whether or not an accountant acted recklessly in connection with a particular audit." Netterville Letter, *supra* note 68, at 5.

70. *Private Litigation Under Federal Securities Laws: Hearings Before the Comm. on Banking, Housing and Urban Affairs, Subcomm. on Securities*, 102d Cong., 2d Sess. 342 (1993) [hereinafter *Securities Hearings*] (testimony of A.A. Sommer, Jr.).

71. Netterville Letter, *supra* note 68, at 1.

Supreme Court of New Jersey, in *Rosenblum v. Adler*,⁷² a privity matter, clearly saw the rule as a means of shifting costs incurred by victims to society as a whole through the large insurance cover carried by accountants. It is telling—and ironic—that a principal justification for the public policy change announced by this decision was the presumed ready availability of accountants' liability insurance at a reasonable cost.⁷³

But today, the comfortable assumption that individual economic losses can be harmlessly transformed into social costs must be challenged. The insurance cover has shrunk significantly and, for many firms, is virtually non-existent. Litigation costs are thrown back upon individual shareholders and consumers through higher prices for products and services. No policy doctrine can justify the lopsided shift of liability without culpability that joint and several liability permits.

In one of the seminal cases regarding accountants' liability, Judge Benjamin Cardozo, while discussing privity, recognized as early as 1931 the harmful consequences of overextending auditors' liability:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. *The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.*⁷⁴

The *Bily* court, expressing specific concern over “liability out of proportion to fault,”⁷⁵ reached the same conclusion more than sixty years later:

An award of damages for pure economic loss suffered by third parties raises the spectre of vast numbers of suits and limitless financial

72. 461 A.2d 138 (N.J. 1983).

73. Said the court:

Independent auditors have apparently been able to obtain liability insurance covering these risks or otherwise to satisfy their financial obligations. We have no reason to believe that they may not purchase malpractice insurance policies that cover their negligent acts leading to misstatements relied upon by persons who receive the audit from the company pursuant to a proper business purpose.

Rosenblum, 461 A.2d at 151 (citation omitted). Reflecting the dramatic increase in litigation exposure for the accounting profession during the past decade, the *Bily* court rejected this view. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 764 (Cal. 1992).

74. *Ultramares v. Touche*, 174 N.E. 441, 444 (N.Y. 1931) (emphasis added).

75. *Bily*, 834 P.2d at 762.

exposure The auditing CPA has no expertise in or control over the products or services of its clients or their markets; it does not choose the client's executives or make its business decisions; yet, when clients fail financially, the CPA auditor is a prime target in litigation claiming investor and creditor economic losses because it is the only available (and solvent) entity that had any direct contact with the client's business affairs.⁷⁶

The *Bily* court concluded:

Given the secondary "watchdog" [as opposed to "bloodhound"] role of the auditor, the complexity of the professional opinions rendered in audit reports, and the difficult and potentially tenuous causal relationships between audit reports and economic losses from investment and credit decisions, the auditor exposed to negligence claims from all foreseeable third parties faces potential liability *far out of proportion to its fault*.⁷⁷

A recent independent study confirms that the availability of an accounting firm as a deep pocket defendant increases the expected value of a settlement.⁷⁸ Based on an analysis of more than 100 shareholder class action settlements between July 1991 and June 1993, two economists at National Economic Research Associates, Inc., discovered that "the inclusion of law firms, accounting firms or underwriters as codefendants adds over 50 percent to the expected settlement value of a shareholder class action."⁷⁹ In the course of this two-year period, the NERA study found that the average settlement in cases involving an accounting firm was nearly double the settlement amount in cases involving no accountants.⁸⁰ The study concludes that, because no other variable can explain this phenomenon, "[t]hese observations are consistent with the hypothesis that settlement values are higher when more deep pockets are involved," and with "the theory that settlement size is driven by the ability to pay."⁸¹

By guaranteeing the availability of a "deep pocket" regardless of fault, joint and several liability encourages plaintiffs' lawyers to file as many suits as

76. *Id.* at 763 (emphasis added).

77. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 761 (Cal. 1992) (emphasis added).

78. FREDERICK C. DUNBAR & VINITA M. JUNEJA, RECENT TRENDS II: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS (National Economic Research Assoc., Inc. 1993) [hereinafter NERA STUDY].

79. *Id.* at ii.

80. *Id.* at 6, 15, Table 11.

81. *Id.* at 6, 11.

possible without regard to merit. Virtually all of these cases will settle and produce a fee for plaintiffs' lawyers because the threat of joint and several liability, the vagaries of the applicable legal standard, and the unpredictability of the litigation make defendants settle even if they have a good defense. Thus, each time a professional judgment is made in each audit, the auditor faces potentially massive liability, because joint and several liability threatens a defendant whose culpability is minimal with responsibility for the entire damage award—which, in shareholder class action suits, can be extremely large.

IV. JOINT AND SEVERAL LIABILITY THREATENS THE CONTINUED VIABILITY OF THE AUDIT FUNCTION

What Judge Cardozo feared in *Ultramares*, and what the California Supreme Court readily acknowledged in *Bily*, are unfortunately borne out all too tangibly, particularly in federal securities litigation. The two factors discussed above—a murky legal standard that threatens innocent accountants with the prospect that their judgments will be viewed, in hindsight, as reckless; and a liability standard that makes a marginally culpable defendant responsible for 100% of the damages—combine to force defendants to settle. The apparently widespread assumption that there are costless remedies for any loss has led to out-of-control litigation, especially with respect to Rule 10b-5 securities class actions. The result is an enormous problem that threatens the future of the audit function.

A. *The Major Accounting Firms Face Massive Exposure in Litigation*

The cost to the public accounting profession of insuring itself against threatened legal action, and the high cost of defense and settlements, are large and growing larger. At least one firm, the seventh-largest, has been forced into extinction.⁸² Insurance companies have rapidly and consistently withdrawn from the market of insuring the profession.

Capable partners, facing unprecedented exposure of their life savings to risk, are on the verge of leaving their chosen vocation. Retired partners fear the loss of retirement benefits. It is more and more difficult for accounting firms, operating as partnerships whose members' lifetime assets are vulnerable to litigation, to attract and retain the "best and brightest" in their field. The profession's independent Public Oversight Board warns of the consequences:

82. Laventhol & Horvath filed for bankruptcy on November 21, 1990. Alison L. Cowan, *Bankruptcy Filing By Laventhol*, N.Y. TIMES, Nov. 22, 1990, at D1.

[T]he litigation risks confronting the profession pose serious dangers to its ability to perform its assigned role in society There is ample anecdotal evidence that the liability threat is a factor students are now taking into account in determining whether to pursue a career in public accounting. There have been instances of promising young managers refusing partnerships . . . because of concerns with exposing their personal assets to litigation risks. There have also been instances in which these concerns were important factors in the decision of partners to leave public accounting for corporate positions.⁸³

An understanding of the accounting profession's litigation exposure illustrates all too well the reasons behind these disquieting trends. As the six largest firms reported to the Securities and Exchange Commission in June 1993, currently pending claims against them of more than \$30 billion represent more than twenty times the combined partners' capital in all six firms.⁸⁴ Furthermore, a rising percentage of accounting firms' audit and accounting revenues is now devoured by litigation costs. It is the fastest-growing expense of the six largest firms, increasing by nearly fifty percent during the past two years. Net practice protection costs⁸⁵ now equal almost eleven percent of the six firms' accounting and audit revenues—or, on average, nearly \$100 million per firm in 1992 alone. Table I below illustrates these costs.⁸⁶

83. POB REPORT, *supra* note 60, at 9.

84. This material and that which follows were submitted to the SEC on June 11, 1993, in response to questions from Chief Accountant Walter Schuetze. See A Disproportionate Burden of Liability, Report of the Six Firms to SEC Chief Accountant Walter Schuetze (June 11, 1993) [hereinafter First SEC Submission]. The data were collected from the accounting profession's six largest firms: Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and Price Waterhouse. The six firms use different fiscal years and different accounting classifications. In compiling the firms' collective data, therefore, some judgments were required to arrive at the most consistent presentation possible. Additional material was also submitted in a follow-up letter to Mr. Schuetze on September 24, 1993 [hereinafter Second SEC Submission]. (The First and Second SEC Submission reports are on file with the SEC's Office of Chief Accountant.)

85. For purposes of this analysis, accounting and audit practice protection costs include liability insurance, plus accounting and audit judgments and settlements, outside legal fees, and the direct cost of internal legal departments, net of insurance recoveries.

86. First SEC Submission, *supra* note 84, at 2.

Table I. Accounting and Audit Practice Protection Costs
(in millions)

	1990	1991	1992
Gross accounting and audit revenues	\$5,257	\$5,319	\$5,470
Costs of judgments, settlements, and legal defense	\$367	\$485	\$783
Gross costs as percentage of revenues	7.0%	9.1%	14.3%
Insurance premiums net of insurance recoveries (credit)	\$37	\$(8)	\$(185)
Net audit practice protection costs	\$404	\$477	\$598
Net costs as percentage of revenues	7.7%	9.0%	10.9%

As Table I shows, actual litigation costs, before considering the impact of insurance, have more than doubled over the past two years. These costs now represent more than fourteen percent of the six firms' accounting and audit revenues. If today's trend continues as expected, litigation costs will have absorbed an even higher percentage of revenues in 1993. These costs to the accounting profession are far greater than similar costs incurred by any other American business or profession except small aircraft manufacturers—before most of them abandoned the business.⁸⁷

Because insurers must charge higher premiums to make up for prior losses, the firms entered 1993 facing major built-in higher charges against future earnings, along with extremely high deductibles and reduced coverage. Inexorably, the situation is deteriorating to a point where the profession may be altogether unable to obtain commercial insurance, because no insurer will be willing to underwrite the litigation risk involved.

Furthermore, in addition to the exploding practice protection costs summarized in Table I, there is a heavy additional cost in time and talent diverted from the principal mission of the six firms' auditing practices—providing the investing public with assurance regarding the reliability of the financial information that corporate managements disclose. When a lawsuit is brought, the attention of management personnel directly associated with the audit in question—from the office managing partner to the line auditors—must focus

87. U.S. production of general-aviation aircraft fell to 880 planes in 1992 from a peak of 17,811 in 1978, and it is reported that "lawsuits helped send the small-plane business into a death spiral." William M. Bulkeley, *Small-Plane Makers May Get a Big Lift from Congress*, WALL ST. J., Oct. 19, 1993, at B1.

on defending the lawsuit. Given the considerable number of suits the firms face, the diversion of human resources is substantial.

Litigation, in particular, consumes a significant portion of senior management's time. For example, one firm's Vice Chairman of Accounting and Auditing estimates that litigation-related matters absorb at least twenty percent of his time—time lost from his primary responsibilities to respond to the needs of users of financial statements by developing new audit methodologies and consulting on complex financial reporting matters.⁸⁸ All six firms share similar experiences: litigation management claims too much attention, detracting from their ability to improve the way they fulfill their mission.

The six firms' litigation-related costs not only are growing enormously, they are far higher than similar costs to other professions and businesses. One study estimates that U.S. tort costs consume 2.3% of our country's annual gross domestic product.⁸⁹ The cost to the six firms, seen in Table I, is more than *four times* larger, although there is absolutely no evidence that the profession's performance is substandard in comparison to other economic sectors. To the contrary, objective measures—numbers of government enforcement actions, results of the AICPA peer review process, and studies of the auditor's effect on financial reporting—all indicate that the profession's work is of high quality.

B. The Cost of Defending the Large Number of Meritless Cases Is Disproportionately High When Compared to the Accountants' Level of Responsibility

The major accounting firms incur tremendous defense costs, and are forced to pay settlements, in numerous cases that are without merit. The low settlements, in comparison to the damages claimed, or outright dismissals in these cases demonstrate that the accountants had little or no responsibility for the alleged misconduct. Yet the threat of joint and several liability, together with rapidly escalating legal costs, made settlements a virtual necessity.

88. First SEC Submission, *supra* note 84, at 3.

89. This study by Tillinghast, a Towers Perrin Company, reports that the cost of the U.S. tort system—at 2.3% of the GDP—is approximately two and one-half times the average relative cost of tort systems in major European countries as well as in Australia and Japan. TORT COST TRENDS: AN INTERNATIONAL PERSPECTIVE 14 (Tillinghast 1992) [hereinafter Tillinghast]. Further, tort costs in other major nations show negligible growth, compared with a U.S. cost spiral since 1983. *Id.* at 15.

The information gathered by the six firms leaves no doubt that meritless claims impose very large—and disproportionate—costs on accounting firms. A survey by the six largest firms of the cases against them involving Rule 10b-5 claims that were concluded in fiscal year 1991 showed that (1) the average claim subjecting the firm to joint and several liability was for \$83 million; (2) the average judgment or settlement by the firm was \$2.7 million; yet (3) the average legal cost the firms paid per claim was \$3.5 million.⁹⁰ *In other words, in the average case concluded in 1991, a major accounting firm paid \$800,000 more in legal defense costs than in settlement payout—which itself, on average, is a mere three percent of the original claim, suggesting that the claim had little or no merit.*

The gross data submitted by the six largest accounting firms to the SEC further confirm that accountants are frequently victimized by meritless suits.⁹¹ In 1992, for instance, the six largest firms closed sixty-two audit-related cases involving Rule 10b-5 claims. Of these sixty-two cases, twenty-five were dismissed before trial. Those twenty-five cases completely vindicated the accounting firms that defended their audits. But vindication did not come cheaply: the six firms spent more than \$10 million successfully defending those twenty-five cases. Another eleven of the 1992 cases were settled for \$150,000 or less. Such a small payment essentially represents no more than the nuisance value of the suit. In order to achieve this result, however, the firms spent over \$8 million more in defense costs for these eleven cases.⁹² Thus, even the weakest Rule 10b-5 lawsuit entails substantial defense costs. And the costs just discussed were all incurred in cases resolved *before* trial. The cost of proceeding to trial in cases like this is simply prohibitive.

It is not surprising, then, that Robert Levine, former CEO of Laventhol & Horvath, the seventh-largest U.S. accounting firm when it filed for bankruptcy in 1990, said at the time, with respect to the burden of securities fraud claims: “‘It wasn’t the litigation we could lose that was the problem. It was the cost of winning that caused the greatest part of our financial distress.’”⁹³ Like other large accounting firms, according to Levine, Laventhol was sued repeatedly because of the perception of it being a deep pocket, not because it failed to meet its professional responsibilities.⁹⁴ One study found that eighty percent of the

90. 138 CONG. REC. S12604 (daily ed. Aug. 12, 1992) (statement of Sen. Sanford (D-NC), introducing Securities Private Enforcement Act of 1992).

91. First SEC Submission, *supra* note 84, at 3-4.

92. *Id.*

93. Editorial, *Looking Back*, PUBLIC ACCOUNTING REPORT, SPECIAL REPORT, Nov. 30, 1991, at 2 (on file with the *Valparaiso University Law Review*).

94. *Id.*

cases against Laventhol settled for nuisance value or less.⁹⁵ The cost of defending countless meritless suits simply proved too much for Laventhol to bear.

Tables II, III, IV, and V—which are drawn from data presented by the six largest accounting firms to the SEC—illustrate the inordinate resources consumed by this litigation.⁹⁶ Table II describes the six firms' total audit-related litigation experience over the past three years. Tables III, IV, and V show the firms' combined experience with certain types of lawsuits, including federal securities claims.

Table II. Audit-Related Litigation, All Cases

	1990	1991	1992
Total amount of awards and settlements paid*	\$89.6 M	\$160.3 M	\$752.4 M
Amount of awards and settlements per audit partner	\$19,865	\$37,900	\$185,737
Number of cases settled	52	67	115
Amount of settlements*	\$54.4 M	\$146.6 M	\$748.3 M
Number of cases dismissed	23	29	79
Number of cases tried	9	7	15
Number of verdicts for defendants	3	3	12
Number of verdicts for plaintiffs	6	4	3
Total amount of awards to plaintiffs*	\$35.2 M	\$13.7 M	\$4.1 M

* These amounts represent the total awards and settlements in cases closed in the years indicated, regardless of when the firms recorded the specific amounts in their income statements. Hence, these figures do not relate consistently to the figures in Table I.

95. *Id.*

96. First SEC Submission, *supra* note 84, at 14 (Table II), 16 (Table III). Second SEC Submission, *supra* note 84, at 6 (Table IV), 9 (Table V).

Table III. Audit-Related Cases Including 10b-5 Claims

	1990	1991	1992
Total amount of awards and settlements paid	\$58.5 M	\$85.3 M	\$373.8 M
Amount of awards and settlements per audit partner	\$13,964	\$20,166	\$92,278
Number of cases settled	12	24	35
Amount of settlements	\$36.5 M	\$77.3 M	\$373.8 M
Number of cases dismissed	7	11	23
Number of cases tried	1	4	0
Number of verdicts for defendants	0	3	0
Number of verdicts for plaintiffs	1	1	0
Total amount of awards to plaintiffs	\$22.0 M	\$8.0 M	\$0

Includes all cases that contain a Rule 10b-5 claim, even if other federal and state claims were also alleged in the complaint. There is a minuscule number of cases, not included in this table, that are brought in federal court but that do not involve a Rule 10b-5 claim.

Table IV. Audit-Related Cases Where Rule 10b-5 Claims Are the Only Federal Securities Law Claims

	1990	1991	1992
Total amount of awards and settlements paid	\$19.3 M	\$15.0 M	\$234.3 M
Amount of awards and settlements per audit partner	\$4,278	\$3,546	\$57,838
Number of cases settled	5	15	19
Amount of settlements	\$19.3 M	\$7.0 M	\$234.3 M
Number of cases dismissed	5	7	14
Number of cases tried	0	2	0
Number of verdicts for defendants	0	1	0
Number of verdicts for plaintiffs	0	1	0
Total amount of awards to plaintiffs	\$0	\$8.0 M	\$0

Includes all cases containing Rule 10b-5 claims, even if the complaint also alleged other non-securities federal or state claims.

Table V. Audit-Related Cases Containing Only State Law Claims,
with No Claims Under Federal Securities Laws

	1990	1991	1992
Total amount of awards and settlements paid	\$31.1 M	\$72.8 M	\$378.5 M
Amount of awards and settlements per audit partner	\$6,894	\$17,210	\$93,434
Number of cases settled	39	40	78
Amount of settlements	\$17.9 M	\$67.1 M	\$374.4 M
Number of cases dismissed	16	18	54
Number of cases tried	8	3	15
Number of verdicts for defendants	3	0	12
Number of verdicts for plaintiffs	5	3	3
Total amount of awards to plaintiffs	\$13.2 M	\$5.7 M	\$4.1

Includes all cases containing no federal securities law claim, even if the complaint also alleged other federal claims.

These data clearly show the “hydraulic” pressure forcing settlements due to the threat of joint and several liability, particularly in Rule 10b-5 class action suits (where the vague “recklessness” standard has created so much litigation uncertainty). In fact, while actions under Rule 10b-5 represent less than thirty percent of the total cases closed in 1990, 1991, and 1992, they account for more than fifty percent of the firms’ settlement payments during that period.⁹⁷ This heavy pressure to settle imposes an *in terrorem* effect on defendants whose connection to the alleged principal wrongdoing is tenuous or remote. Defendants believe they have little choice, even if the claims against them are relatively empty. Due to the risks and costs of litigation, then-SEC Chairman Richard Breeden remarked that “companies settle weak or even meritless claims on essentially the same terms as they settle meritorious claims.”⁹⁸

Conversely, many more state than federal claims went to trial—another indication of the extraordinary pressure on defendants facing joint and several liability to settle Rule 10b-5 actions. The reason is simple: the cost of proceeding to trial is prohibitive, even if the accountant’s legal position is quite

97. *Id.* at 3.

98. Richard C. Breeden, Chairman, Securities and Exchange Commission, Remarks at the Corporate Counsel Institute, Chicago, Illinois 8 (Oct. 16, 1991) [hereinafter Breeden Remarks] (on file with the *Valparaiso University Law Review*).

strong, because potential responsibility for the entire amount of damages is so great. In this respect, the doctrine of joint and several liability "actually encourages plaintiffs' lawyers to ignore the merits of their case and sue every potentially liable party with deep pockets, even if the party was not involved in the fraud."⁹⁹

Significantly, the only academic study to examine federal securities fraud litigation against accountants found that auditors are more frequently dismissed from a case, or make a very low payment, than other types of defendants. Professor Zoe-Vonna Palmrose of the University of Southern California found that "the evidence [with respect to Rule 10b-5 claims] was consistent with meaningful levels of weak litigation. This finding applied to all defendants, but was much more applicable to auditors than to all other defendants."¹⁰⁰ Moreover, because the data indicate a "high cost" to auditors of defending against these weak cases, "*the evidence supports auditors' arguments that they bear a disproportionate share of litigation costs.*"¹⁰¹

C. *The Problem Is Large, and Growing Larger*

During the past five years, the number of shareholder class actions against accountants and others has escalated considerably, as reported by the Administrative Office of the U.S. Courts. In 1988, there were 108 filings, while in 1992 that number had reached 268.¹⁰² These statistics paint an alarming picture, as more cases were filed in the past three years than in the previous seven years combined, and the number in each of the three years was more than double the number in nearly any of the earlier years.¹⁰³

Far more important than the raw number of cases filed, however, is their profile. Rather than being ordinary business disputes between two parties, these cases are among the largest actions in the federal judicial system. The data are compelling. A conservative projection of the damages sought in the 268 class actions suits filed in just one year, 1992, amounts to \$10.7 billion, and those cases involved an estimated 734,000 separate claimants. Similarly, the cases

99. Netterville Letter, *supra* note 68, at 7.

100. Zoe-Vonna Palmrose, *The Joint and Several Versus Proportionate Liability Debate: An Empirical Investigation of Total Resolutions on Audit-Related Litigation* 27 (Sept. 1993) (preliminary draft, on file with the *Valparaiso University Law Review*).

101. *Id.* at 23 (emphasis added).

102. *Securities Hearings*, *supra* note 70, at 121 (statement of William R. McLucas).

103. *Id.* The Securities Class Action Alert estimates that "total cash settlements of shareholder class action lawsuits against companies of all sizes nearly quintupled to \$1.55 billion in 1992 from \$324 million in 1988. In the same period, the number of suits settled jumped to 144 from 53, and the average cash settlement increased to \$10.8 million from \$6.1 million." Brent Bowers & Udayan Gupta, *Shareholder Suits Beset Small Companies*, WALL ST. J., Mar. 9, 1994, at B1.

pending in 1992 carried claims of more than \$25 billion and involved an estimated 1.7 million claimants.¹⁰⁴ The problem is growing, too. The monetary value of these lawsuits, for instance, adjusted for inflation, has ballooned by sixty-six percent over the past fifteen years. (This figure was derived by comparing average settlements in 1974-75 with those in 1989-90.)¹⁰⁵ The unproductive impact of these suits on the economy has thus grown dramatically.

Even the American Bar Association, not necessarily an advocate for accountants, in a letter to Senator John Kerry (D-Mass.) and Representative Ron Wyden (D-Or.), commenting on the latter's proposed Financial Fraud Detection and Disclosure Act, stated that:

[P]rivate actions against CPA firms under the federal securities laws are currently instituted at the slightest provocation The liability exposure currently faced by CPA firms is not only real and substantial, but it is also having a material adverse impact on the accounting profession. It is no secret that each of the large accounting firms is currently facing multiple claims for hundreds of millions of dollars. At the same time, liability insurance coverage is diminishing. As a result, the six largest firms are no longer able to litigate securities law class actions to a final resolution since an adverse outcome could be life-threatening.¹⁰⁶

D. American Businesses May Lose the Services of Accounting Firms

In 1992, the California Supreme Court in *Bily* expressed concern that expanded accountants' liability would cause "deleterious economic effects."¹⁰⁷ Rejecting the claim by the *Rosenblum* court that expanded auditor liability would promote significant improvement in auditing, the *Bily* court said that "[i]n view of the inherent dependence of the auditor on the client and the labor-intensive nature of auditing, we doubt whether audits can be done in ways that would yield significantly greater accuracy without disadvantages."¹⁰⁸ Presciently, the court added:

104. *Securities Hearings*, *supra* note 70, at 720, 726 (letter from American Business Conference, American Electronics Association, American Institute of Certified Public Accountants, Association of Publicly Traded Companies, and National Venture Capital Association to Senator Christopher Dodd).

105. *Id.* at 723.

106. Letter from ABA Section of Business Law to Sen. John Kerry and Rep. Ron Wyden 5-6 (July 2, 1993) [hereinafter ABA Letter] (on file with the *Valparaiso University Law Review*).

107. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 765 (Cal. 1992).

108. *Id.* at 766.

*Auditors may rationally respond to increased liability by simply reducing audit services in fledgling industries where the business failure rate is high, reasoning that they will inevitably be singled out and sued when their client goes into bankruptcy regardless of the care or detail of their audits. As a legal economist described the problem: "[T]he stronger the probability that liability will be incurred when performance is adequate, the weaker is the deterrent effect of liability rules. Why offer a higher quality product if you will be sued regardless whenever there is a precipitous decline in stock prices?"*¹⁰⁹

The *Bily* court's prediction has proven correct. The chain reaction of negative effects on American business from the current class action system includes the advent of more-stringent risk management programs by audit firms. Managing risk now focuses on vulnerability to litigation, not only on the ability to perform a quality audit. Consequently, many promising but higher-risk companies are beginning to be deprived of the best professional expertise.¹¹⁰

This often occurs at the most promising but vulnerable moments in a business's life. One large accounting firm, for example, has decided in the past year to refuse well more than twenty opportunities to prepare clients for initial public offerings of their securities.¹¹¹ Another firm chose to walk away from major portions of its banking practice, at an especially difficult period for the industry.¹¹² In general, due to litigation exposure, there is unwillingness today to offer new services that could be extremely helpful, such as association with expanded disclosure of risks and uncertainties and reporting on prospective financial information.¹¹³

109. *Id.* (emphasis added; citation omitted).

110. As recently noted, the "[a]vailability of [a]ccounting [i]nformation is [c]ritical to [s]moothly [f]unctioning [c]apital [m]arkets If auditors are forced to riddle their audit opinions with disclaimers to stave off liability, securities analysts will lose a valuable source of information that is critical to price predictions. Consequently, without the widespread availability of financial information, securities pricing would become less predictable" David A. Jaffe, *The Allocation of Fault in Auditor Liability Lawsuits Brought by Sophisticated Third Party Users of Financial Statements—A Plea for Proportionate Liability*, 54 U. PITT. L. REV. 1051, 1079 (1993).

111. This raises the cost of capital for such companies. As a result, banks and private equity investors will be less willing to commit funds to companies that are unable to retain independent auditors. Where investment capital can be obtained, it will be more expensive because investors will require a higher rate of return as compensation for the additional risk engendered by lack of adequate financial disclosure. *Id.* at 1082.

112. Vincent Michael Valce, *Ernst & Young Closing Its CT Banking Practice*, *BANKER & TRADESMAN*, May 1993.

113. Kelly Holland & Larry Light, *Big Six Firms are Firing Clients*, *BUS. WEEK*, Mar. 1, 1993, at 76-77.

In fact, growing numbers of smaller accounting firms in recent years have stopped performing audits altogether. A recent survey of California CPA firms found that only fifty-three percent will undertake audit work—and, among those firms, thirty-two percent are discontinuing audits in what they consider to be high-risk economic sectors.¹¹⁴ Similarly, a study by insurance consultants Johnson & Higgins found that fifty-six percent of the mid-sized accounting firms they surveyed refuse to do business with clients in industries the firms judge to be high-risk.¹¹⁵

In sum, as the American Bar Association's Section of Business Law recently observed with alarm:

[A]ll of the "Big Six" firms are currently reassessing their clientele and are terminating audit clients where they perceive the liability risks to be disproportionately large in relation to the associated fee income The trend is even stronger with respect to small and medium size CPA firms, many of which are abandoning SEC practice (and, in some cases, all audit practice). A recent poll by a task force of the California State Society of CPAs showed a significant drop (approximately 6%) over a two-year period in the number of CPA firms engaged in audit practice In short, the accounting profession simply cannot withstand any further increase in its liability exposure if it is to continue to audit the financial statements of public companies.¹¹⁶

V. JOINT AND SEVERAL LIABILITY'S ADVERSE ECONOMIC EFFECTS REACH WELL BEYOND THE ACCOUNTING PROFESSION

A. *The Current System Fails to Compensate Shareholders Fairly*

It is not only the accounting profession that has suffered as a result of joint and several liability. The hard fact is that the current liability system does not protect investors, despite its historical origins in exactly this policy impulse. Three investors' representatives who recently testified before the Securities Subcommittee of the U.S. Senate Banking Committee all made precisely this point. One of them, Maryellen Andersen of the Connecticut State Retirement and Trust Funds, said that reform "must be addressed to ensure that the system

114. Lee Berton, *Legal Liability Awards Are Frightening Small CPA Firms Away from Audits*, WALL ST. J., Mar. 3, 1992, at B1.

115. THE JOHNSON & HIGGINS FINANCIAL GROUP, PROFESSIONAL LIABILITY AND THE CERTIFIED PUBLIC ACCOUNTANT: HOW THE PROFESSION IS RESPONDING (1990).

116. ABA Letter, *supra* note 106, at 6.

protects us as investors, employees, retirees and citizens.”¹¹⁷ Ralph Whitworth, who as executive director of the United Shareholders’ Association spoke for 65,000 investors, charged that our system of private rights of action for securities fraud has evolved into a game of “gotcha” litigation punctuated by wars of legal attrition.¹¹⁸ And Patricia Reilly, a plaintiff in two Rule 10b-5 class action cases, asserted that “security class action lawsuits exist for the benefit of the shareholders’ lawyers. The stockholders, the victim of the fraud, recover virtually none of their losses.”¹¹⁹

The views of these investors about today’s malfunctioning system should be given great weight. After all, the federal securities laws and Rule 10b-5 in particular were designed to protect investors. Yet their sworn testimony, together with numerous research studies, confirms that the litigation system is not effectively compensating investors who are truly injured by fraud.

1. Investors Recover Very Little of Their Alleged Damages

Research findings put dollars and cents on the charge that today’s system does not truly compensate investors. Professor Janet Cooper Alexander’s study of class actions against smaller high-tech companies in Silicon Valley, for example, found an average settlement rate of twenty-six cents on the dollar—with twenty-seven percent subtracted from that amount to pay attorneys’ fees.¹²⁰ Furthermore, a broader National Economic Research Associates study of shareholder class action settlements between July 1991 and June 1993 showed that investors recover only approximately seven cents on the dollar *before* an award of attorneys’ fees. Finally, a comprehensive 1993 study led by Dr. Vincent O’Brien found a median recovery rate to investors of only four cents on the dollar.¹²¹

117. *Securities Hearings*, *supra* note 70, at 324 (testimony of Maryellen Andersen).

118. *Id.* at 364 (statement of Ralph Whitworth).

119. *Id.* at 45 (testimony of Patricia Reilly).

120. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 507-519 (1991).

121. NERA STUDY, *supra* note 78, at 4; VINCENT E. O’BRIEN & RICHARD W. HODGES, A STUDY OF CLASS ACTION SECURITIES FRAUD CASES 1988-1993, at II-3 (1993). More specifically, the NERA study showed that 84 settlements in cases involving total investor losses of approximately \$17.8 billion generated only approximately \$547 million in settlements (6.98%). NERA STUDY, *supra* note 78, at 4, Table 6.

In a letter to Senator Pete Domenici (R-NM), the State of Wisconsin Investment Board, which serves as investment manager for pension funds of public employees in Wisconsin and which manages more than \$33 billion, noted that a sampling of its files of shareholder class actions in which its has been involved showed that “cases settled for an average of approximately 11% of the total amount of plaintiff damages certified to the court. In one instance, the recovery was only 1% of certified loss Attorney fees and costs consistently take the lion’s share of recoveries in situations where plaintiffs go largely uncompensated for their losses.” Letter from Kurt N. Schacht

Well-known class action attorney William Lerach, at one of the 1993 Securities Subcommittee hearings, asserted that the average settlement rate is actually sixty cents on the dollar, calling the other studies faulty because they compared the settlement amount to the plaintiff's entire market loss—not to the (smaller) damages that a plaintiff could recover. But a study of the twenty cases cited by Mr. Lerach, which he characterized as a "representative sample" of securities class actions, contradicts his assertion. The average settlement amount in those cases was only twenty-three percent of the legally recoverable damages. Moreover, where attorney fee information was available (thirteen of the twenty cases cited by Mr. Lerach), the study found that the plaintiffs' attorneys received, on average, thirty-nine percent of the settlement fund in fees and expenses. Thus, the recovery that actually reached the investor/plaintiffs—determined by subtracting from the settlement amount the fees and expenses awarded to the plaintiffs' attorneys—was only about fourteen percent of the legally recoverable damages.¹²² Plainly, such meager compensation is inadequate for true victims of fraud.

For a sad but typical illustration, take the case of Patricia Reilly, who has been a class member in two different cases. The first, against Pace Membership Warehouse, settled for \$9,125,000. Attorneys for the class sought a fee of forty percent of the settlement, plus a further \$600,000 in expenses. After Ms. Reilly traveled at her own expense from California to Colorado to challenge the fee, the court awarded the attorneys roughly thirty percent of the settlement—\$3,300,000. The shareholders will receive an estimated fifteen to seventeen cents for every dollar they lost. In the second case, against Tucson Electric, Ms. Reilly fared even less well. The company settled for \$30 million. The class's attorneys, claiming rates up to \$500 per hour, walked away from the case with \$7,845,000—which included a \$4.8 million premium above their total billings. One of the plaintiffs' attorneys told Ms. Reilly that class members can expect to receive only four or five cents on their lost dollars.¹²³

The plainspoken Ms. Reilly, who also testified before Senator Dodd's subcommittee, wonders:

to Senator Pete Domenici 1, 2 (Sept. 27, 1993) [hereinafter Schacht Letter] (on file with the *Valparaiso University Law Review*).

122. *Securities Hearings*, *supra* note 70, at 708 (letter from Mark Gitenstein to Martha Cochran (Aug. 6, 1993)). It should also be noted that NERA's analysis of the relation between market loss and plaintiffs' damage estimates (NERA STUDY, *supra* note 78, at 7) supports the credibility of this critique of Mr. Lerach's approach.

123. *Securities Hearings*, *supra* note 70, at 44-45 (testimony of Patricia Reilly).

Ms. Reilly concluded: "As a stockholder, I feel that the lawyers use the stockholders as stepping stones, preying on their misfortune, as a means to file a lawsuit that will inevitably settle, in which the lawyers will reap millions in fees while their clients recover pennies on the dollars of their losses." *Id.* at 132.

[F]or whose benefit are these lawsuits brought and then settled? . . . [I]t only stands to reason that 96% of the cases settle. It is in the best interest of the lawyers to settle. If the case goes to trial and the shareholders lose . . . the shareholders' lawyers do not get anything. Of course, if the case settles, the shareholders still get virtually nothing, but at least their lawyers make millions . . . [T]he suits are really brought so that the lawyers can suck money out of insurance companies.¹²⁴

2. Plaintiffs' Class Action Counsel Have an Inherent Conflict of Interest

Part of the economic burden on investors in shareholder class actions emerges from the lawyers' role. Plaintiffs' attorneys in these cases receive only minimal monitoring from their ostensible clients. Essentially, these attorneys function "as entrepreneurs who bear a substantial amount of the litigation risk and exercise nearly plenary control over all important decisions in the lawsuit."¹²⁵ The attorney, not the client, controls the litigation, and "the

124. *Id.* at 136 (testimony of Patricia Reilly). Some critics of reform in shareholder class action litigation argue that the requirement for court approval of settlements safeguards against inadequate settlement amounts and outrageous attorneys' fees. But this argument displays little understanding of the reality of the judicial process today. Since few plaintiffs have adequate incentives to undertake the time-consuming expense of following the case closely or challenging the settlement, court approval is essentially a rubber stamp. As two legal scholars put it:

[J]udicial approval appears to be highly imperfect as a protection . . . for several reasons. First, and most important, the judge herself has a powerful interest in approving the settlement. Judges' calendars are crowded . . . [and] the workload only seems to increase. If the judge approves the settlement, the result will be to remove a potentially complex and time-consuming case from the judge's calendar; if she rejects it she faces a substantial probability of further litigation. A judge faces virtually no prospect of reversal for approving a settlement, whereas a decision rejecting a settlement might well be appealed. Moreover, trial judges are heavily conditioned by the ethos of their jobs to view settlements as desirable . . .

[S]ettlement hearings are typically pep rallies jointly orchestrated by plaintiffs' counsel and defense counsel. Because both parties desire that the settlement be approved, they have every incentive to present it as entirely fair.

Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiff's Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 45-46 (1991).

The courts want to approve settlements because anything that reduces their crowded dockets is helpful. If the suit is meritless and the defendant settles for nuisance value, no one has an incentive to challenge the settlement: the defendant has judged it less expensive to settle than to seek vindication at trial, and the plaintiffs are getting an unexpected windfall, even if a small one. Furthermore, approval of a low settlement may signify the court's view that the case has relatively little merit. If the settlement is too low relative to the damages suffered, the defendant and the plaintiffs' lawyers will be satisfied, while plaintiffs as individuals each have too little at stake to spend the money required to challenge the settlement in person.

125. Macey & Miller, *supra* note 124, at 3.

identified plaintiff operates almost always as a mere figurehead."¹²⁶ Indeed, "it is clear that the current system gives plaintiffs' attorneys a far greater interest in shareholder class actions than any of the plaintiffs they represent. This creates an inherent conflict of interest Plaintiffs' attorneys are clearly in the drivers seat."¹²⁷

William McLucas, enforcement director of the SEC, recently testified to the same point, asserting that "class action counsel tends to operate in an entrepreneurial capacity rather than as a fiduciary operating at the direction of the client."¹²⁸ Mark Griffin of the North American Securities Administrators Association testified similarly, with understatement, that "there may be an inherent conflict in the attorney-client relationship in class action suits which goes somewhat unchecked by ethical concerns, because of the large amounts of money involved."¹²⁹ In fact, in a recent interview in *Forbes* magazine,

126. *Id.* at 5. As Ralph Whitworth put it: "[T]he client's role is being overtaken or supplanted by people whose interests diverge radically from that of the clients." *Securities Hearings, supra* note 70, at 364 (testimony of Ralph Whitworth).

127. Schacht Letter, *supra* note 121, at 1-2.

128. *Securities Hearings, supra* note 70, at 117 (statement of William R. McLucas).

129. *Id.* at 53 (testimony of Mark Griffin).

Given this reality, it is not surprising that outright abuses occur in shareholder class action cases. For example, so-called "cookie cutter" complaints are brought within days (or even hours) of the announcement of bad corporate news or an adverse stock movement; obviously, the time is too short to permit any investigation of whether fraud occurred. Such claims are brought by only a handful of firms that have perfected the techniques involved—to the point of computer-tracking stock prices in order to generate nearly instantaneous complaints linked to price movements. One federal judge in New York recently dismissed a batch of similar complaints alleging that an investment company made misrepresentations in placement memoranda it offered to investors:

The court is confronted with 27 equally frivolous complaints filed by the same law firm It appears . . . as if the complaints were spun out of a word-processed original, with little attention to the details

Each complaint is as groundless as the next. . . . Indeed, it seems impossible that the drafters of these complaints could have read the memoranda. If they had . . . they would have discovered that their allegations were entirely frivolous.

Kushner v. DBG Property Investors, Inc., 793 F. Supp. 1161, 1181 (S.D.N.Y. 1992). This was no isolated instance. Of 46 cases that the *National Law Journal* studied, 12 were filed within one day and another 30 within one week of publication of unfavorable news about the defendant company. Milt Policzer, *They've Cornered the Market*, NAT'L L.J., Apr. 27, 1992, at 1, 34. Philips N.V., a Dutch electronics giant traded on the New York Stock Exchange, was named in a class action suit "just hours" after announcing that its 1992 operating profit was unlikely to match its 1991 profit of \$566 million. *Bloomberg Business News, Philips Sued on Prospects for Earnings*, N. Y. TIMES, June 18, 1992, at D4. Compaq Computer Corp. was sued one day after announcing a drop in earnings; it took Apple Computer six days to receive the same treatment after a similar announcement. Common sense suggests that anyone who files suit within hours or days of such complex events has not investigated the facts, let alone reached the level of scrutiny needed to find a reasonable basis for alleging fraud.

The use of "professional plaintiffs" is also widespread. Harry Lewis, a retired lawyer, has reportedly been lead plaintiff in an estimated 300 to 400 lawsuits; William Weinberger, a retired

plaintiffs' class action attorney William Lerach brashly noted, "I have the greatest practice of law in the world: I have no clients."¹³⁰

Since plaintiffs' lawyers work on a contingency basis in a wide variety of actions, the unique attorney's conflict of interest in shareholder class actions cannot be blamed on the contingency arrangement alone. As one legal scholar and former federal official notes: "The principal difference lies in the fact that in a substantial number of class action cases the lawyer will be more prone to settle than would the class, whereas in other contingent fee situations such a difference in view between client and lawyer is less likely."¹³¹

Judge Henry Friendly, longtime chief judge of the U.S. Court of Appeals for the Second Circuit, effectively summarized this unique conflict of interest for plaintiffs' attorneys:

There can be no blinking at the fact that the interests of the plaintiff in a stockholder's derivative suit and of his attorney are by no means congruent. While, in a general sense, both are interested in maximizing the recovery, this is only a half-truth. Even apart from special considerations which . . . may cause special divergence of interest in cases where extremely large amounts are at stake, . . . there is a difference in every case. The plaintiff's financial interest is in his share of the total recovery less what may be awarded to counsel, simpliciter; counsel's financial interest is in the amount of the award to him less the time and effort needed to produce it. A relatively small settlement may well produce an allowance bearing a higher ratio to the cost of the work than a much larger recovery obtained only after extensive discovery, a long trial and an appeal. The risks in proceeding to trial vary even more essentially. For the plaintiff, a defendant's judgment may mean simply the defeat of an expectation, often of relatively small amount; for his lawyer it can mean the loss of years of costly effort by himself and his staff. In this respect a derivative action is in a quite different posture from a personal injury action conducted on a contingent basis. We say this not in criticism

accountant, has been a plaintiff in more than 90 suits. In Los Angeles, surgeon Steven Cooperman has appeared as a plaintiff in 19 suits, but he must yield the local title to Rodney Shields, a retired lawyer, who has made 20 Los Angeles appearances as a plaintiff in securities suits. See Policzer, *supra*, at 1, 34; see also Andrew Leigh, *Being a Plaintiff Sometimes Amounts to a Profession*, INVESTOR'S BUS. DAILY, Nov. 1, 1991, at 8; Nancy Rutter, *Securities Class Action Scandal*, UPSIDE, Apr. 1990, at 16-17, 32.

130. William P. Barrett, *I Have No Clients*, FORBES, Oct. 11, 1993, at 52.

131. Kenneth W. Dam, *Class Actions: Efficiency, Compensation, Deterrence, and Conflict of Interest*, 4 J. LEGAL STUD. 47, 57 (1975).

but in simple recognition of the facts of class action life.¹³²

Thus, most cases settle because plaintiffs' attorneys have an inherent bias toward settlement that meshes well with the coercive effect of joint and several liability on deep pocket defendants who have been joined to a particular case solely for their settlement value. And, in general, the earlier the settlement, the more the attorneys will profit:

Attorneys compensated on a percentage method have an incentive to settle early for an amount lower than what might be obtained by further efforts. The attorney who puts in relatively few hours to obtain an early settlement is likely to earn a much greater compensation per hour of effort than an attorney who expends greater efforts and litigates a case to the point where the plaintiffs' recovery is maximized. *Again, the plaintiff class loses.*¹³³

B. Investors and the National Economy Pay Too Much for Litigation Abuses

Investors are damaged by abusive litigation not only when they fail to gain adequate compensation. When companies in which they hold equity incur inordinately high expenses fighting frivolous suits, the value of investors' holdings suffers. Beyond that, of course, the long-term health of the entire economy is compromised. Ms. Andersen eloquently summarized these harmful effects in her testimony:

[We investors] are the ones who are hurt if a system allows someone to force us to spend huge sums of money in legal costs by merely paying ten dollars and filing a meritless cookie cutter complaint against a company or its accountant, when that plaintiff is disappointed in his or her investment If we saddle our companies with big and unproductive costs that other companies in other countries do not pay, we cannot be surprised if our jobs and raises begin to disappear and our pensions come up short as the population ages.¹³⁴

Judge and professor Ralph K. Winter argues that the American legal system unnecessarily raises the costs of capital and thus brakes national economic growth. He also observes that investors reap little, if any, benefit from class

132. *Saylor v. Lindsley*, 456 F.2d 896, 900-01 (2d Cir. 1972).

133. *Macey & Miller*, *supra* note 124, at 22 (emphasis added). Again, in Ralph Whitworth's words: "[T]he managers of these lawsuit factories that specialize in these suits, their incentive is to maximize their share of the settlement at the earliest time possible and move on to the next case." *Securities Hearings*, *supra* note 70, at 306 (testimony of Ralph Whitworth).

134. *Securities Hearings*, *supra* note 70, at 323 (testimony of Maryellen Andersen).

actions because of their huge transaction costs. For instance, he notes that "some investors will suffer a loss from the indemnification of the defendants and the funding of the costs of litigation for all parties. Investors who are diversified against such transfers will suffer a net loss from the costs of the litigation. Investors who receive damages will benefit, but the amounts will not be great."¹³⁵ Judge Winter concludes:

Derivative and class actions extract a deadweight loss from investors. In most such actions, the corporation receives no benefit but pays everyone's legal fees. In some cases, a benefit is received but is either paid from insurance that was purchased by the corporation or offset by indemnification. *Because settlement is guided only in small part by the merits of the underlying claim, derivative and class actions result in the overcompensation of weak claims and the undercompensation of strong claims.* Investors thus also lose because fiduciary or statutory obligations—which I assume to be efficient—are not effectively enforced.¹³⁶

C. The Class Action System Encourages Less, Not More, Disclosure

The broad impacts of frivolous class action suits reach beyond the immediate distortion of recovery by those with real losses. Everyone agrees that our capital markets operate most fairly and efficiently if investors have as much information as possible about the companies in which they invest. That is why the SEC has historically encouraged companies to make voluntary disclosures of information beyond the required minimum.

But the current securities litigation system, perversely, discourages managements from disclosing the very type of information that is essential for intelligent investor decisions. As a matter of fact, these lawsuits create incentives to withhold information—precisely the opposite effect of what the securities laws were meant to accomplish.

In a 1993 study of 550 companies' patterns of information disclosure, two University of California professors show that fewer than fifty percent of companies with earnings significantly above or below analysts' expectations released early information voluntarily.¹³⁷ Moreover, companies are significantly more reluctant to disclose good news than bad news—good news,

135. Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 951 (1993).

136. *Id.* at 952 (emphasis added).

137. Ron Kasznik & Baruch Lev, *The Characteristics and Consequences of Corporate Discretionary Disclosures* (May 1993), *reprinted in Securities Hearings, supra* note 70, at 675.

of course, would create valuation of their securities at a level that could come back to haunt them if future results were not as positive. The study concludes that fear of litigation causes a widespread pattern of minimal disclosure.¹³⁸

A recent survey confirms these findings. The National Venture Capital Association, in a survey of 212 companies, found that seventy-one percent were more reluctant to discuss company performance with market analysts.¹³⁹ The CEO of one company that was the subject of eight class action lawsuits in 1992 after it reported that its third-quarter earnings would be lower than projected (the suits were ultimately dismissed after the company spent more than \$100,000 in litigation costs), now reports that it is “‘afraid to talk about the upside.’”¹⁴⁰ In the company’s upcoming annual report, “‘there isn’t a single line that says what we’re aiming for. We’re not making any projections because by their very nature we could be wrong.’”¹⁴¹

The testimony of several high-tech company CEOs during the Securities Subcommittee hearings in the summer of 1993 confirms this chilling effect. Richard Egan, CEO of EMC Corporation of Massachusetts, explained that the company now takes a “defensive posture” in its public statements and is reluctant to make public forecasts because of litigation concern.¹⁴² John Adler, CEO of Adaptec, a California high-tech firm, testified that many companies in Silicon Valley “have adopted a ‘no communications’ policy. That means they say nothing beyond what they must disclose by law.”¹⁴³ Scott McNealy, CEO of Sun Microsystems, talked about his company’s policy of offering only “limited guidance” to Wall Street analysts. The company no longer releases earnings and revenue projections and refuses to comment directly on analysts’ projections. The company decided that the legal risks of providing such information were too high.¹⁴⁴

In a similar vein, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AICPA) is meeting strong resistance to its proposal for expanded corporate disclosures of risks and uncertainties. AICPA’s former chairman Jake Netterville testified at the recent Senate hearings that many commentators opposed the committee proposal on the

138. *Id.* See also Michael A. Hirsch, *C'mon Corporate America, Don't Be So Shy*, ORANGE COUNTY REG. (California), Nov. 21, 1993, at 3 (“Louis Thompson, Jr., president and chief operating officer of the National Investor Relations Institute, believes companies are shutting the information flow because they fear lawsuits from disappointed shareholders.”).

139. Bowers & Gupta, *supra* note 103, at B1.

140. *Id.* (quoting Peter Behrendt, chief executive officer of Exabyte Corp.).

141. *Id.*

142. *Securities Hearings, supra* note 70, at 17 (testimony of Richard J. Egan).

143. *Id.* at 104 (statement of John G. Adler).

144. *Id.* at 594 (statement of Scott G. McNealy).

grounds that it will increase liability exposure.¹⁴⁵ The evidence that this chilling effect is real and widespread is uncontradicted.

D. Shareholder Class Action Litigation Disproportionately Affects High-Tech and Growth Companies

The present system seriously harms the American economy. It diverts resources that would otherwise fuel technical innovation and job creation, both badly needed to grow the economy and to improve the competitiveness of U.S. firms. Indeed, the principal impact of meritless Rule 10b-5 class action litigation falls heavily on the new and emerging companies that generate the largest number of new jobs.¹⁴⁶ Furthermore, some extend that criticism, such as William McLucas of the SEC, who believes that "to the extent that these baseless claims are settled to avoid . . . litigation, the system imposes a tax on capital formation."¹⁴⁷

The system, in short, obstructs capital formation and job creation. Yet federal regulation of our capital markets is intended, as a matter of public policy, to make it easier for companies to raise capital, create jobs, attract investors, and contribute to economic growth. Policymakers must be concerned that today's system does just the opposite.

CEOs of high-technology companies who testified at the Securities Subcommittee hearings—representing more than 150 companies employing 585,000 people—stressed this broadly damaging economic effect. Richard Egan,

145. *Id.* at 300-01 (testimony of Jake Netterville).

146. Indeed, the recent NERA study found that almost one out of every three settlements within its two-year sample involved high-tech companies. NERA STUDY, *supra* note 78, at 5; VINCENT E. O'BRIEN & RICHARD W. HODGES, A STUDY OF CLASS ACTION SECURITIES FRAUD CASES, at I-8 (1991). The NERA study concluded: "[A] disproportionately large number of securities class action settlements continue to be suits against high-technology firms," which suggest[s] that plaintiffs sometimes recover damages when innocent stock price volatility, rather than fraud, causes the stock price to fall. . . . [W]e remain troubled by the continued unusually large number of settlements from high-technology firms The prevalence of suits against high-technology firms suggests that a stock price drop in response to a timely disclosure is as likely to cause a complaint to be filed as is a stock price drop from the disclosure of a cover-up. At least for some cases, the merits would then be of secondary importance.

NERA STUDY, *supra* note 78, at i, 1, 17.

Similarly, the National Venture Capital Association survey, *see supra* text accompanying notes 142-44, found that in its survey of 212 companies, "more than one in six young, publicly traded companies said that they had been defendants in such suits, some more than once. The suits—most of which are still pending—have already eaten up an average of 1,055 hours of management time each and \$692,000 in legal fees." Bowers & Gupta, *supra* note 103, at B1.

147. *Securities Hearings*, *supra* note 70, at 37 (statement of William R. McLucas).

EMC's chief executive, observed that

companies will not take sound risks but will manage their operations so as to maintain steady performance and avoid stock fluctuation . . . Management time will be diverted to defend these lawsuits and U.S. corporations will remain at a disadvantage because you must constantly think short term in order to deliver acceptable financial results every 90 days, rather than focusing on long-term development, a disadvantage with which most of our foreign competitors do not have to contend.¹⁴⁸

Similarly, Edward McCracken of Silicon Graphics called the current system "an uncontrolled tax on innovation" that is "impacting real creation of jobs,"¹⁴⁹ and John Adler, Adaptec CEO, testified that these lawsuits stifle "innovation . . . creation of jobs, corporate govern[ance] and world-wide competitiveness."¹⁵⁰

Frivolous Rule 10b-5 class action litigation puts American companies on an uphill slope against companies in Japan and Europe that do not face this perpetual burden of litigation. In 1991, tort costs in Japan and Great Britain ran well below one percent of national output, while U.S. costs consumed more than twice as much of the nation's gross domestic product.¹⁵¹ The chairman of a medium-sized high tech firm observes, "In Japan, executives spend their time doing business. They don't have to deal with such nonproductive efforts as litigation. We are going to get our clocks cleaned this way."¹⁵²

Abusive suits cut into the meat of American businesses' ability to pursue the research and development needed for new ideas and products. John Adler of Adaptec says the litigation costs of the "multimillion dollar fishing expedition" conducted against his company in a class-action suit "would have paid for 20 additional engineers."¹⁵³ Ed McCracken, Silicon Graphics' CEO, recently gave National Public Radio his view of the bottom-line damage of frivolous litigation to American business:

[Our firms] are betting on new technologies and new products. They're trying to produce change and, as a result, create jobs and

148. *Id.* at 18 (testimony of Richard J. Egan).

149. *Id.* at 12 (testimony of Edward R. McCracken).

150. *Id.* at 29 (testimony of John G. Adler).

151. Tillinghast, *supra* note 89, at 14.

152. Rutter, *supra* note 132, at 34, 88.

153. John G. Adler, *A Frivolous Securities Suit Claims Another Victim: Me*, WALL ST. J., Sept. 15, 1993, at A23.

growth in today's economy —and that, in itself, requires taking some risks. When you take risks, sometimes they don't work out. And so these lawsuits, in some ways, encourage firms to take fewer risks. And also, of course, the money that we spend on defending these lawsuits is money that comes right out of our research and development programs.¹⁵⁴

In sum, as Peter Behrendt, chief executive officer of Exabyte Corp., put it: “These suits are a major threat to entrepreneurial companies.”¹⁵⁵

E. Class Action Litigation Makes It Increasingly Difficult to Attract Qualified Independent Directors

The liability exposure fostered by the current shareholder class action system creates another concern: fewer and fewer qualified individuals are willing to serve on corporate boards of directors because they are nearly always sued when their companies are sued. For obvious reasons, these individuals do not want to put their life savings and reputations at risk in order to defend against allegations of fraud, no matter how meritless. Ironically, the availability of experienced outside directors is declining at precisely the time when demand for them is growing.

Clear evidence traces this trend. For example, Jean Head Sisco, Chairperson of the National Association of Corporate Directors and currently an outside director on eight boards, stated recently that

the proliferation of these abusive 10b-5 securities suits has caused a crisis in corporate governance because of the difficulty in attracting qualified, independent directors. More and more companies are finding it virtually impossible to fill their board of directors positions with qualified individuals because these unwarranted securities class action suits expose outside directors to personal liability¹⁵⁶

Furthermore, sixty percent of the members of the American Business Conference stated in response to a survey that the possibility of being sued has forced them to weigh more carefully the decision to join a board; twenty-four percent refuse to serve on boards of start-up firms and other companies that are

154. *All Things Considered*, Report by Elaine Korry (National Public Radio, Aug. 6, 1993).

In sum, “securities fraud lawsuits are so complex that even the most frivolous ones eat up lots of time, generate truckloads of paperwork and cost companies a bundle.” Rob Perez, *More Companies Fighting Securities Fraud Lawsuits*, BUSINESS, Dec. 26, 1993, at D3.

155. Bowers & Gupta, *supra* note 103, at B1.

156. *Securities Hearings*, *supra* note 70, at 644 (statement of Jean Head Sisco).

especially vulnerable to securities fraud suits.¹⁵⁷

The inability to attract experienced independent directors especially damages small, high-tech and growth companies, which often must rely on an experienced board as a relatively inexpensive means of obtaining expertise as well as independent oversight on behalf of shareholders. For all companies, however, the help and guidance that come from experienced outside directors have become further casualties of the class action system.

VI. PROPORTIONALITY: A MUCH-NEEDED REFORM

To alleviate the increasingly damaging effects of class action suits in tort litigation spurred by joint and several liability, the existing concept of comparative fault should be joined by the parallel concept of proportionate liability. As a practical matter, something must be done to break the magnetic attraction of plaintiffs' lawyers to deep pocket defendants, regardless of the merits of a case.

In our view, the most effective way to protect investors would be to reform the current litigation system—which now generates only cynicism while failing to motivate compliance—and, at the same time, to activate a swift and sure disciplinary process for accountants who do substandard work, as the AICPA has already proposed in a June 1993 report by its board of directors.¹⁵⁸ One of the report's other major recommendations was adoption of a proportionate liability standard in federal securities suits as well as in other claims against accountants. As we have seen, proportionality is not a novel idea or a radical departure from American legal norms. Thirty-seven states have reformed their tort laws by enacting some form of proportionate liability in order to deter meritless litigation against deep pocket defendants. There is also legislation pending in both the House of Representatives and the Senate that would, in different ways, apply proportionate liability to securities litigation brought pursuant to the Securities Exchange Act of 1934.¹⁵⁹

Reforming the doctrine of joint and several liability would help to relieve some of the nonmerits-based pressure to settle these abusive suits—thereby

157. American Business Conference 1993 survey of members, *reported in Securities Hearings*, *supra* note 70, at 104 (statement of John Adler). The American Business Conference is a group of 100 CEOs of mid-sized American companies with revenues of more than \$25 million.

158. AICPA BOARD OF DIRECTORS, MEETING THE FINANCIAL REPORTING NEEDS OF THE FUTURE: A PUBLIC COMMITMENT FROM THE PUBLIC ACCOUNTING PROFESSION 6 (June 1993).

159. In the House of Representatives, H.R. 417, introduced by Congressman W.J. (Billy) Tauzin (D-La.) on Jan. 5, 1993, currently has more than 80 co-sponsors. Senators Christopher J. Dodd (D-Conn.) and Pete Domenici (R-N.M.) introduced S.1976 on Mar. 24, 1994. See 140 CONG. REC. S6695-3707 (daily ed. Mar. 24, 1994).

eliminating the incentive to bring them in the first place. Accountants and other marginal defendants would no longer be deterred from proving their innocence at trial out of fear of widely disproportionate liability. Plaintiff's lawyers would be discouraged from naming deep pocket defendants with only a tangential relationship to the underlying transaction. This would reverse the perverse incentives of class action suits in particular. "Because the amount of recovery from each defendant will be limited by the degree of the defendant's involvement, the merits of the claim will matter more to the plaintiffs' lawyers than the depth of the defendant's pocket."¹⁶⁰

An independent academic who has recently studied class action cases believes that a proportionate liability rule would likely reduce the incidence of meritless litigation against auditors in particular.¹⁶¹ In Professor Palmrose's words, the proposed reform of joint and several liability "should reduce plaintiffs' estimates of the expected value from including marginal defendants in much litigation under the 1934 Act. *This should have the desired effect of reducing auditors' involvement in weak litigation.*"¹⁶²

More importantly, by reducing the incentive to bring numerous meritless suits, a proportionate liability standard would introduce incentives for plaintiffs' attorneys to pursue redress for people who have truly been defrauded. In general, reform should beneficially affect recovery rates in meritorious cases, while helping to clear court calendars by reducing the number of weak claims. Plaintiffs' lawyers are now compensated for volume. By removing the opportunity for easy money offered by meritless litigation, the system could instead create powerful incentives for these lawyers to pursue genuine fraud. In sum, proportionate liability would build into the system precisely the incentives we should want: to obtain more money for investors with good cases and to stop the filing of cases with no merit.

Installing a rule of proportionate liability is likely to have ancillary consequences that will strengthen our capital markets and economy. For instance, reducing the anxiety about frivolous litigation that is so costly to defend will encourage broader disclosure of useful corporate information, as well as expanded audits that encompass more relevant though subjective data such as prospective information. These can only make for wiser investor decisions and a more-informed allocation of the limited capital resources available in our country.

Proportionate liability will also protect the many thousands of current

160. Netterville Letter, *supra* note 68, at 7.

161. Palmrose, *supra* note 100, at 27-28.

162. *Id.* at 28 (emphasis added).

investors who lose money when the companies in which they have invested are plundered by meritless suits and defense costs. Now, companies victimized by such suits pay huge sums in attorney fees and settlements to dispose of the suits and get back to business. Those costs amount to money filched from the pockets of shareholders, diverted from productive uses, such as research and development, that would raise the value of their investments while creating new jobs for other Americans.¹⁶³

Defenders of the status quo argue that proportionate liability harms investors' ability to recover damages caused by fraud—a basic goal of the securities laws. Far from it. Providing for proportionate liability does not let wrongdoers off the hook. Joint and several liability should continue to apply whenever a defendant, including an auditor, is found to have participated knowingly in fraudulent activity.¹⁶⁴ Further, as previously noted, the new incentives arising out of the reforms discussed here should encourage a more intense pursuit of claims where investors have been truly defrauded, raising recovery rates in those cases. A system based on proportionality simply asks that a plaintiffs' lawyer *prove* the amount of harm that a defendant caused his client. This approach better fits the principles underlying our adversarial

163. Critics of reform argue that, if meritless securities litigation is a problem, existing provisions of federal law can solve it. They point primarily to Rule 11 and Rule 9(b) of the Federal Rules of Civil Procedure. In fact, neither is an adequate tool.

Courts are reluctant to impose sanctions under Rule 11, even where complaints appear completely empty of merit. One of the witnesses at the recent Senate hearings offered a classic example of the problem: even though the complaint against the corporation of which he is CEO was, in the court's words, "a fishing expedition at the defendant's expense," Rule 11 sanctions were denied. *Securities Hearings, supra* note 70, at 17 (statement of Richard J. Egan). Furthermore, seeking sanctions under Rule 11 is costly. The defendant has needlessly increased his already high costs if sanctions are denied. Even if they are awarded, a defendant is not entitled to recover the cost of defending the ruling on appeal. Proceeding under Rule 11 is for most companies, therefore, only an invitation to pay higher defense costs. Most firms choose to cut their losses.

Furthermore, Rule 11 has been weakened substantially by a revision that became effective on December 1, 1993. Under the revised Rule 11, injured parties would have fewer incentives to challenge opponents' actions because awards of sanctions would be permissive, not mandatory. Monetary penalties would be paid to the court, not the injured party. Narrowing the range of awardable costs, Rule 11 would also no longer apply to the costly discovery process.

Under Rule 9(b), fraud claims must be pleaded with particularity. But the rule has a large loophole when applied to 10b-5 claims: only two federal courts of appeals require the pleading of particular facts showing that the defendant acted with fraudulent intent. In other courts, a *plaintiff may simply assert that the defendant made a representation "with fraudulent intent"—without setting forth any facts to establish intent.* This loophole allows plaintiffs to proceed with a case without alleging any facts showing that a misstatement or omission was a knowing lie, as opposed to an inability or entirely innocent failure to predict the future accurately. This mortally wounds a defendant's ability to cut off a meritless lawsuit.

164. This is consistent with the conclusion of several states, which, while adopting proportionate liability as the general rule, have created an exception for intentional torts. *See supra* notes 32-33 and accompanying text.

system, since, as a matter of equity, a judgment should be entered against a defendant only to the extent that evidence demonstrates culpability. Requiring proof of a link between a defendant's actions and an alleged harm is hardly a radical departure from the American tradition—rather, it reaffirms our legal system's fundamental values.

Opponents of proportionate liability also argue that accountants bear a great deal of responsibility for the harms caused by fraudulent securities activities. If that is true, however, plaintiffs' lawyers have nothing to fear from proportionate liability: they will simply be required to present the evidence to a jury and to demonstrate the level of damages for which an auditor is responsible. These class action lawyers cannot have it both ways. If accountants are culpable for the losses they allege, they should have no trouble proving that level of responsibility before a jury.

Advocates of the status quo argue, finally, that even if there is some unfairness to some defendants, such as accountants, in a system of joint and several liability, it is even more unfair to leave a so-called "innocent" investor with no recovery, which is what critics claim proportionality would do. While rhetorically appealing, this argument is ultimately unpersuasive.

First, the oft-invoked "innocent investor" is a misnomer. Indeed, if apportioning liability between plaintiffs and defendants makes sense, and the joint and several liability rule is reformed in cases of personal injury and property damage (as many states have now done), modification is fairer still in cases of investment losses. Any person who suffers harm as a result of intentional misconduct should, of course, be compensated for the injury. But the degree to which one is truly a victim varies by the specific circumstances of the alleged harm. A person injured by a product that he purchased is truly an innocent victim because he has a reasonable and legitimate expectation that the product purchased is safe and free from defects. In contrast, a person who participates in the stock market by investing in an enterprise does so with the understanding that certain financial risks exist and with the motivation to make a profit. While the person who buys a product rightfully assumes that all products are safe, the investor knows (or should know) that some investments will be winners and others losers, especially in today's economic environment of rapid change.¹⁶⁵ Unfortunately, many investors ignore the reality that the coin of reward has an obverse side of risk and responsibility. Former SEC

165. See Jaffe, *supra* note 110, at 1077 ("A fundamental difference between business tort plaintiffs and classic tort plaintiffs [i.e., plaintiffs alleging personal injuries] stems from the consensual nature of commercial activity. Unlike typical tort plaintiffs, business tort plaintiffs . . . knowingly put themselves at risk of economic loss by voluntarily engaging in business transactions in the first place.").

Chairman Richard Breeden recognized that "litigation in all too many cases may be seen as the route for trying to recover what may have been market losses. In effect, some investors may seek a system of 'Heads I win, tails I sue.'"¹⁶⁶

Second, investors' "right" to a full recovery is illusory now. As discussed above, an analysis of twenty cases proffered by a class action plaintiffs' lawyer during the Senate Securities Subcommittee hearings illustrated that investors obtain a net recovery of only fourteen percent of their legally recoverable damages.¹⁶⁷ As discussed earlier, proportionality would likely increase recovery for investors who are truly harmed by forcing plaintiffs' lawyers to seek more damages in cases with merit. In addition, proportionality would help investors in companies victimized by meritless suits by deterring such cases and preventing the diversion of corporate time and money from productive work.

Finally, proportionality will not, by definition, substantially alter recovery in the large segment of cases in which (1) all defendants are solvent, (2) there is one solvent defendant that is jointly and severally liable for having knowingly engaged in fraudulent activity, or (3) most defendants, or the defendants who are most culpable, are solvent.

VII. CONCLUSION

Claims under the federal securities laws are only one category of suits against accountants, but they vividly demonstrate the need to reform a system that is predicated on joint and several liability and whose original policy and economic rationales are no longer being served. The basic intent of the federal securities laws was to protect investors from genuine loss, while fostering an orderly capital market based on open procedures. Achieving these goals was meant to encourage investment and promote national economic development.

As our discussion has suggested, however, the outcomes of today's litigation system do not serve these goals and, indeed, promote the reverse of what was intended. Instead of protecting investors from genuine loss, the class action system offers low returns to genuine victims and imposes high costs on shareholders and companies that are the engines of growth. Instead of curbing legal abuses, the present system rewards high-volume litigation of meritless cases and compensates injured investors in minuscule percentages. Instead of fostering an orderly market based on open procedures, today's system encourages nondisclosure and threatens high-risk enterprises with withdrawal of the services they need most. It is no wonder that a recent study of settlements

166. Breeden Remarks, *supra* note 98, at 9.

167. See *supra* text accompanying notes 120-22.

in shareholder class action cases concluded: "Without overstating our statistical findings, if one had to choose among the most important of three factors in explaining settlements—stock price volatility, availability of assets and merits of the case—it would appear that the merits matter the least."¹⁶⁸

Thirty-seven states, recognizing the abuses of joint and several liability that have caused these unhealthy developments, have installed some form of liability based on proportionality. But these welcome reforms are inadequate to curb existing abuses and to meet in a timely fashion the goal of promoting national economic development.

Embodying proportionality in the federal securities laws will move strongly toward restoring the original public policy intentions of those laws. The further step of preempting state law to ensure that the same ground rules apply in all cases alleging accountants' malpractice—as recently recommended by the Public Oversight Board—would be even more decisive and beneficial.

As this Article has illustrated, proportionate liability is neither a novel concept nor a radical departure from American legal norms. It would install a proper mix of incentives to ensure desirable public policy outcomes, while removing the perverse incentives that now exist. A system based on proportionate liability would protect and compensate the truly injured better than the present system does. By deterring meritless litigation and redirecting incentives for plaintiffs' attorneys to seek sound cases instead of high volumes, it would put more help where it is needed—with those who suffer genuine losses. The same dynamic would encourage those who are blameless to defend themselves instead of settling. A not-unwelcome further dividend of reform is likely to be a reduction in the flow of frivolous cases through overcrowded courts.

More broadly, proportionality would help to recover an historic purpose of any democratic legal system: to provide an orderly, just, relatively predictable framework that offers equitable dispute resolution, creating the cornerstone of a more productive economy. The consequences of an absent or distorted legal framework are all too evident in the halting economic development of many countries today.

A rule of proportionality, as this chapter suggests, would also do much to reopen the free flow of business information and disclosure, benefiting both investors and lenders. In addition, experienced business people who today fear liability exposure from corporate board service would become available again.

168. NERA STUDY, *supra* note 78, at 16.

Finally, by removing the threat of wildly disproportionate liability, a rule of proportionality would restore the full availability of necessary services that accountants and others are withdrawing today. Both businesses and investors would benefit enormously, but the ultimate beneficiary would be the American public, through a more open, competitive economy in a thriving global marketplace.