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The Liability of Corporate Officials to Their Outside Auditor for Financial Statement Fraud

Cover Page Footnote
THE LIABILITY OF CORPORATE OFFICIALS TO THEIR OUTSIDE AUDITOR FOR FINANCIAL STATEMENT FRAUD

Michael R. Young*

INTRODUCTION

To some, the prospect of an auditor being able to sue a corporate official because of misstated financial statements may seem exactly backward. Many would argue that it is fundamentally the responsibility of the auditor to see that financial statements are fairly presented. After all, only the independent CPA generally may issue an audit report. If the subject of that report turns out to be false, corporate officials might assert, is it not the auditor who should be liable to them?

Not necessarily. Less than four years ago, an informal survey of lawyers by The Wall Street Journal could uncover only a single reported case in which an auditor had filed claims against its client company or management. Today, in addition to dealing with shareholder litigation prosecuted by a seeming cottage industry of class action lawyers, corporate officials have to worry about claims based on false financial statements from what many would consider a wholly unlikely source: the CPAs who audited them.

Relatively little has been written about this aspect of shareholder litigation, for the overwhelming emphasis has been upon the outside auditor as defendant. Throughout the past decade, though, perceived responsibility for fraudulent financial reporting—even as to audited financial statements—has increasingly shifted from the auditor to the company and its management. This shift has resulted in the increasing viability of independent claims by auditors against the officers and directors of their client companies.


1. See, e.g., N.Y. Educ. Law §§ 7401-7402 (McKinney 1985) (providing that only certified public accountants or other similarly licensed practitioners may sign an audit report). See generally Unif. Accountancy Act § 14(a) (2d ed. 1994) ("No person or firm not holding a valid certificate . . . shall issue a report on financial statements . . . .").

2. See Gabriella Stern, Coopers & Lybrand Brings Countersuit Against Phar-Mor Over Firm’s Problems. Wall St. J., Aug. 20, 1992, at A3 ("Attorneys who represent accounting firms recall only one other lawsuit filed as a counterclaim against a client company and its management in the early 1980s. BDO Seidman, the 10th-biggest U.S. accounting firm then known as Seidman & Seidman, sued management of Cenco Corp., a Chicago medical supplies firm, for fraudulently leading Seidman to issue a clean opinion on Cenco."). Actually, the lawyers surveyed by The Wall Street Journal missed a couple. See infra note 73.
This development is significant for at least two reasons. One is that
the auditor may recover from corporate officials substantial damages
in shareholder litigation, even damages the auditor itself paid to settle
shareholder claims. The other is that the mere existence of auditor
claims can preclude corporate officials from settling a class action on
their own, because the corporate officials, even after consummation of
the settlement, may still be vulnerable to litigation from the outside
auditor. In the frequently-encountered situation in which an auditor,
performing the traditional role of deep pocket, declines to settle, the
auditor can virtually preclude a settlement by anyone, no matter how
much money corporate officials are willing to pay.

This study looks at the changing perceptions as to financial state-
ments and, in particular, at the developments over the last decade that
have made corporate officials—and "officials" is meant to include
both officers and directors—particularly vulnerable to outside auditor
claims. It then addresses the potential bases for auditor claims, how
claims by auditors are being treated by the courts, and the implica-
tions of such claims, particularly as to class action settlements.

I. CHANGING PERCEPTIONS AS TO FINANCIAL STATEMENTS

A. Pre-Treadway

In a sense, corporate officers and directors have always been theo-
retically vulnerable to auditor claims should their financial statements
turn out to be false. It is an explicit component of the auditor-client
relationship that the financial statements are the responsibility of the
company's management.\(^3\) At the heart of audit testing pursuant to
generally accepted auditing standards ("GAAS") has always been
management-generated data.\(^4\) Where that data is false, it is fairly
straightforward to find the elements of a claim for intentional or negli-
gent misrepresentation and to conclude, as a matter of law, that a
claim by the auditor exists.

Still, auditor litigation against a company and its management never
really seemed to get off the ground. Perhaps part of the reason in-
volved a tactical decision by the outside auditor caught up in share-
holder litigation that the filing of cross-claims or third-party claims
against corporate officials would only operate to throw gasoline on the
litigation fire. In part, an auditor's reluctance to make such claims
may have resulted from a sense that auditor litigation seeking to place
blame on others ran against the grain of unsophisticated, albeit con-
tventional, wisdom, which incorrectly held the auditor accountable for
practically everything the financial statements said. In part there was
probably a recognition that claims against company management
would result in claims by management against the auditor, and that in

\(^3\) See AICPA Professional Standards AU § 110.02 (1995).
\(^4\) See id. AU §§ 326.14 to .18.
such a battle the auditor might well come up with the short end of the stick.

Whatever the explanation, the last several years have witnessed developments that are changing the dynamic. Officers and directors are coming to be viewed as having increased responsibility for their company’s financial statements, and auditors are correspondingly coming to be viewed as having less. At the same time, the law and the trail of available evidence increasingly point to the financial reporting culpability of corporate officers and directors where the financial statements turn out to be false. The tactical balance has changed.

B. The Treadway Commission

One of the biggest catalysts for change has been the Report of the National Commission on Fraudulent Financial Reporting, commonly known as the report of the Treadway Commission. Named after its chairman, former Securities and Exchange Commission (“SEC”) member James Treadway, and sponsored as a private-sector initiative by the American Institute of Certified Public Accountants (“AICPA”), the American Accounting Association, the Financial Executives Institute, the Institute of Internal Auditors, and the National Association of Accountants, the Treadway Commission during a two-year period studied the financial reporting system in the United States with the goal of identifying the causes of fraudulent financial reporting and what can be done to stop it.

In the contest for first place among those responsible for the prevention of financial fraud, the Treadway Commission picked the company and its management. The Commission’s report opens with the proposition that “[t]he company and its management are the key players in the financial reporting system” and that “they bear the primary responsibility for the preparation and content of the financial statements.” In particular, the Treadway Commission emphasizes “the tone at the top”—the corporate environment or culture within which financial reporting occurs—as “the most important factor contributing to the integrity of the financial reporting process.” It is largely upon the shoulders of the board of directors and senior corporate officers, accordingly, that the Treadway Commission places most of the responsibility for ensuring the integrity of financial statements. The

6. Id. at 1.
7. Id. at 17.
8. Id. at 32.
9. Id. at 31-33. Among the specific recommendations of the Commission are that corporate officials establish an “appropriate tone” and “overall control environment” that foster the integrity of the financial reporting process. Id. at 31. Other recommendations include the design and implementation of a strong internal control system, id.
outside auditor in all this does not get off scot-free. While acknowledging that the financial statements are "first and foremost the responsibility of the management of the reporting entity," the Commission makes clear that "the independent public accountant plays a crucial role" and sets forth specific recommendations to enhance the auditor's effectiveness.\textsuperscript{10} Still, ultimate responsibility is placed squarely upon corporate officials.

The report of the Treadway Commission proved to be something of a watershed. The financial community almost instantaneously came to view its recommendations as authoritative.\textsuperscript{11} Legal writers discussed at length the Treadway report and advocated a level of diligence consistent with its recommendations.\textsuperscript{12} Of particular significance here, the national accounting firms separately took steps to apprise the directors and officers of their client companies as to precisely what was now expected of them according to the report's recommendations. Thus, the accounting firms published their own monographs, duly distributed to corporate officials, which highlighted the recommendations of the Treadway report and outlined their view as to what corporate officials, and audit committees in particular, should be doing.\textsuperscript{13} Management letters, typically issued at the conclusion of an audit engagement, explicitly or implicitly began to assume

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\textsuperscript{10} For example, one report comments, "The Treadway Commission has been hailed by members of Congress, the SEC and others as making a significant contribution to the challenge of reducing the incidence of fraudulent financial reporting." Leonard P. Novello, \textit{Audit Committee Comes of Age}, N.Y. L.J., Dec. 14, 1989, at 5, 6; see also Dingell Plans to Propose Bill to Implement NCFFR Recommendations, 19 Sec. Reg. & L. Rep. (BNA) No. 47, at 1809 (Nov. 27, 1987) (introducing new legislation based on the recommendations of the National Commission on Fraudulent Financial Reporting); Robert K. Herdman & Robert D. Neary, \textit{Before Congress: The SEC Responds to Treadway}, Fin. Executive, Sept./Oct. 1988, at 15 (discussing proposed legislation based on the National Commission on Fraudulent Financial Reporting recommendations that would affect corporate governance, reporting, and enforcement).


\textsuperscript{12} See, e.g., BDO Seidman, Guide to Forming and Running an Effective Audit Committee (1989); Coopers & Lybrand, Audit Committee Guide; Deloitte & Touche, Current Issues for Audit Committees 1992; Ernst & Young, Audit Committees: Func-
the Treadway recommendations as important criteria against which the corporate-governance aspects of internal control systems were to be measured.

While the Treadway report started out as just a private-sector initiative, it has now come very close to establishing a generally accepted standard against which corporate behavior may be measured. Insofar as the report or its contents were communicated to individual directors, audit committee members, or others, it may by this point even have become admissible evidence, available to juries in shareholder litigation as a litmus test for assessing culpability.

C. Other Developments

The increasing significance of the Treadway report did not, however, occur in isolation. It was accompanied by a separate initiative, undertaken by the AICPA, to close the so-called “expectations gap”—the gap between what was feared to be the public's perception of the auditor's role and the auditor's role in fact.14 The impetus behind this initiative was a concern, rooted in the experience of individual firms in audit malpractice litigation, that the public assumed a much greater level of responsibility on the part of the outside auditor than the outside auditor under professional standards was prepared to fulfill.15

Here, too, one of the more significant developments was a clearer allocation of responsibility for financial reporting between corporate officials and the outside auditor.16 One visible result was a revision of the standard form of auditor's report, which now stated explicitly on the face of the report what had earlier been buried in the underlying literature articulating GAAS: that the “financial statements are the responsibility of the Company's management,” whereas the auditor's responsibility is only to “express an opinion on these financial statements based on our audit.”17 While the expectations-gap initiative also involved some assumption by the auditor of increased responsibilities for the detection of fraud,18 it highlighted the primary responsibility as that of corporate management.
Still another development operated to affect the allocation of responsibility for financial reporting between corporate officials and the auditor. That is the much-touted "litigation crisis" and the very real specter that, if things continued as they were going, every national accounting firm was going to be driven out of business. Data made available by the Big Six firms revealed an astonishing $30 billion of potential liability for those firms alone at the end of 1992, roughly $3.8 million per partner. At the same time, headlines advertised not only extraordinary jury verdicts but extraordinary settlements as well. Ernst & Young's $400 million settlement with the federal government appeared in giant headlines on the front page of The New York Times.

Something had to change. And newspaper stories about large verdicts and settlements were soon accompanied by newspaper stories about accounting firms firing their clients. A March 1, 1993 article in Business Week is typical. In an article entitled Big Six Firms Are Firing Clients, Business Week reported: "With growing regularity, major public accounting firms are turning their backs on many smaller banks, thrifts, and fledgling companies. Deloitte & Touche, for one, declined to audit about 60 companies trying to go public last year, more than half the 103 initial public offerings they actually evaluated." Business Week described the reason as "no mys-

19. In a study prepared by the Big Six firms entitled“A Disproportionate Burden of Liability,” those firms observed:

In recent years, the cost to the public accounting profession of insuring itself against threatened legal action and the cost of defense and settlements have created a great threat to the profession’s continued existence. At least one firm, the seventh-largest, has been forced into extinction. Insurance companies have rapidly and consistently withdrawn from the market of insuring the profession.


20. Accounting Firms Predict Dim Future if Joint and Several Liability Remains, 25 Sec. Reg. & L. Rep. (BNA) No. 24, at 872 (June 18, 1993). In 1992 alone, the Big Six firms paid out $783 million in awards, settlements, and defense costs. Id.


It was because "[i]n recent years, accounting firms have been forced to fork over hundreds of millions of dollars to settle lawsuits." 24

The prospect of accounting firms going out of business or firing clients turned the conventional wisdom on its head. The conventional wisdom, typified by the New Jersey Supreme Court's decision in *H. Rosenblum, Inc. v. Adler*, 25 had been that the placement of broad responsibility for financial reporting upon the auditor would operate, among other things, as a mechanism to diversify risk, since readily-available insurance would be available to absorb shareholder claims. 26 The analysis was wrongheaded to begin with, and subsequently proved incorrect. 27 The accounting firms were in trouble.

All of this culminated in renewed scrutiny as to the auditor's responsibility and the extent to which the auditor should be at the forefront of those held accountable for financial fraud. Courts began to take notice. In the thick of this reawakening emerged decisions such as the California Supreme Court's opinion in *Bily v. Arthur Young & Co.*, 28 which scrutinized the role of an auditor and precisely what level of responsibility an auditor of financial statements was assuming. Decisions placing broad responsibilities on auditors such as *Rosenblum* came to be undermined or, in the case of *Rosenblum* itself, reversed by the legislature. 29

As the dust settled, there thus existed widespread and explicit recognition of what sophisticated financial analysts had understood all along: financial reporting was foremost the responsibility of the company's management, and, in the words of the Treadway report, it is the company and its management that bear "primary responsibility for the

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23. Holland & Light, supra note 22, at 76.
24. Id.
26. Id. at 151 ("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.").
27. An April 1992 issue of *Time* magazine, for example, reported, "Increasingly . . . insurers are refusing to offer any coverage at all to accounting firms because the risks are too great and uncertain. . . . Where 15 firms offered audit insurance about five years ago, only three or four still do . . . ." Thomas McCarroll, *Who's Counting?*, Time, Apr. 13, 1992, at 48, 50.
preparation and content of the financial statements." Accompanying this recognition was the prospect of enhanced receptivity by courts, juries, and others to the financial reporting responsibilities of officers and directors. Also accompanying this recognition was more explicit delineation of management's responsibilities in auditor's reports, management letters, CPA firm monographs, and even the Treadway Commission report itself, all in a form potentially admissible into evidence and therefore available to a jury. Fairly well understood were the implications as to litigation against corporate officials by shareholders. Less well understood, but just as important, were the implications as to litigation against corporate officials by the outside auditors themselves.

II. THE BASES FOR LIABILITY

A. The Audit Process and Internal Control

So exactly what can the outside auditor potentially sue officers and directors for? The answer lies in the basics of the audit process and the way it can be frustrated through financial fraud.

At bottom, an audit depends largely upon information that is provided by the company whose financial statements are being audited. The auditor tests that information—through inquiry, observation, and/or independent confirmation—but at the root of the audit process is company-provided data. The auditor is to maintain a degree of "professional skepticism" and not to take everything at face value. And the auditor, under the more recent standards, is required to undertake some level of testing for the purpose of detecting fraud. The underlying presumption, though, is that the company will generally do its best to provide the auditor with accurate data. The basic function

32. See Dan M. Guy et al., Auditing 6 (3d ed. 1993).
33. AICPA Professional Standards AU § 316.16 (1995). The concept of "professional skepticism" is introduced in the literature as follows:

An audit of financial statements in accordance with generally accepted auditing standards should be planned and performed with an attitude of professional skepticism. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Rather, the auditor recognizes that conditions observed and evidential matter obtained, including information from prior audits, need to be objectively evaluated to determine whether the financial statements are free of material misstatement.

Id.

34. Id. AU § 316.05.
35. The concept of "professional skepticism" walks a fine line between a presumption of management's unquestioned honesty, which would make an independent audit somewhat superfluous, and a presumption of management's dishonesty, which would make an independent audit somewhat impossible. Hence the concept that the auditor "neither assumes that management is dishonest nor assumes unquestioned honesty,"

Id. AU § 316.16. A presumption of management dishonesty, the literature cautions, "would be contrary to the accumulated experience of auditors" and would require the
of an audit under GAAS is to allow the auditor to formulate an opinion as to whether the financial statements present fairly the data with which the auditor has been presented. It is not to ferret out fraud.\footnote{36}

These underlying audit concepts are significant to the responsibilities of corporate officials, because it is the officers and directors who bear ultimate responsibility for seeing to it that the information given to the auditor is accurate. It is their responsibility to see that the internal control system generates accurate and reliable information. It is their responsibility to see that the people providing the auditor with information—information that is both empirically verifiable and less-verifiable nuances of business conditions and prospects—are completely honest and candid.\footnote{37}

These are not of course management responsibilities that arise only in the context of an audit; they are management responsibilities that are inherent in corporate governance. Management needs to hire honest people. Management needs to see that corporate personnel are properly motivated. Management needs to put in place an internal control system that accurately captures and records the transactions of the enterprise so that they are properly set forth in internal and external financial data. This is the essence of the “internal control structure”—the process by which the company records and reports financial information.\footnote{38}

\footnote{36. "Generally accepted auditing standards were not designed to uncover the machinations of a dishonest management." Groveman, \textit{supra} note 35, at 85. The responsibility of an auditor to detect fraud may soon be clarified further by the promulgation of a new Statement on Auditing Standards entitled “Consideration of Fraud in a Financial Statement Audit.” See Jane Mancino, \textit{The Auditing Standards Board Reconsiders Fraud in a Financial Statement Audit}, In Our Opinion (Auditing Standards Div. of the AICPA, New York, N.Y.), Jan. 1996, at 1-2 (clarifying the responsibilities of auditors and the application of audit procedures directed to the detection of financial fraud).}

\footnote{37. AICPA Professional Standards AU § 110.02 (1995).}

\footnote{38. \textit{Id.} AU § 319.06. The professional standards break down a company’s internal control structure into three elements: (1) the control environment; (2) the accounting system; and (3) control procedures. \textit{Id.} AU § 319.08. The “control environment” (which is comparable to the “tone at the top” discussed in the Treadway report) is defined to include such factors as management’s philosophy and operating style, the entity’s organizational structure, the functioning of the board of directors and its audit committee, methods of assigning authority and responsibility, management’s control methods for monitoring, and personnel policies and practices. \textit{Id.} AU § 319.09. The “accounting system” is defined to include “the methods and records established to identify, assemble, analyze, classify, record, and report an entity’s transactions and to maintain accountability for the related assets and liabilities.” \textit{Id.} AU § 319.10. “Control procedures” are defined to be “those policies and procedures in addition to the control environment and accounting system that management has established to pro-}
B. What Happens in Financial Fraud

What happens in the context of fraud is that somewhere this internal control structure breaks down. It can happen at a low level—the mistaken employment of a dishonest low-level employee who embezzles company funds. Or it can happen at a much more senior level. A chief executive officer or chief financial officer may place undue pressure on others to generate earnings increases that make some level of overly-optimistic record keeping almost inevitable.39

It so happens that the large-scale frauds typically fall into the latter category. Where isolated dishonesty such as embezzlement is a problem, the extent of the defalcations tend to be isolated and readily quantifiable. In large-scale fraud, in contrast, the originators frequently turn out to include the most senior officials. Under pressure themselves, from shareholders, analysts, creditors, or others, senior management, with the witting or innocent approval of the directors, may push their employees to achieve at all costs an unattainable level of performance. Lower-level employees, fearful for their jobs, bend over backward to comply. The normal self-correcting mechanisms inherent in a company, such as a basic desire of people to do a good job and to be honest, are overridden by pressures created at higher levels. It bears emphasis that here we are talking about real fraud—not the contrived allegations of strike-suit lawyers based on disappointing earnings. When real fraud occurs, it is often the case that "the company's top management, such as the CEO, the president, and the CFO, were the perpetrators."40

The genesis of financial fraud, therefore, is something that must be addressed at a level senior to the most senior executives in the company. There is only one such level: the board of directors. And it is precisely the modern consensus that it is board of director oversight that plays a critical role in preventing and detecting financial fraud. The Treadway report thus observes that "primary responsibility" for financial reporting "lies with top management, overseen by the board of directors."41

vide reasonable assurance that specific entity objectives will be achieved." Id. AU § 319.11.
41. Id. at 40; see also Donald J. Kirk & Arthur Siegel, How Directors and Auditors Can Improve Corporate Governance, J. Acct., Jan. 1996, at 53 ("The panel [appointed by the Public Oversight Board and the SEC practice section of the AICPA] said the time was now for the profession to expand existing 'best practices' by shifting its focus from a compliance and rule-oriented audit to one recognizing the board of directors as its client and by becoming part of what is called a 'corporate governance' approach to improved financial reporting."); Public Oversight Bd., Strengthening the Professionalism of the Independent Auditor 13 (1994) ("[M]ore effective corporate governance depends vitally on strengthening the role of the board of directors.").
For a board of directors ostensibly trying to act in good faith, this can be a terrifying prospect. There are, after all, very real limitations on what a board of directors can do. Certainly it is too much to expect an outside director to fly-speck every number a company generates. And, while directors might be placed on notice when certain numbers appear out of whack, directors can be deceived just like everyone else.

But what a director can do, and what is quintessentially a board-level function, is to make every effort to establish "the tone at the top" and to see to it that firmly embedded in the corporate culture are basic values of honesty, accuracy, candor, and objectivity. It is also quintessentially a board-level function to undertake to see that these values are respected not only as a matter of corporate culture, but that the mechanical processes through which the company records, processes, and reports financial information are given adequate support and resources so that they function in such a way that permits the generation of accurate data. Often the fulfillment of these responsibilities will involve board-level resistance to what is otherwise an overriding goal: the maximization of reported earnings.

A consequence of all this is that, where financial fraud occurs on a less-than-isolated scale, blame may, depending on the circumstances, find its way right to senior management, the board of directors, and the audit committee. To the extent that corporate officials were knowingly involved in the fraud, they will be vulnerable to auditor accusations of intentional misrepresentation. To the extent they share culpability resulting from a failure of diligence or a failure to

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42. The importance of these board-level responsibilities explains in large part the heightened emphasis in the financial community upon the role of the board's audit committee. The Treadway Commission, for its part, is unequivocal. It states: "The audit committee of the board of directors plays a role critical to the integrity of the company's financial reporting." Report of the National Commission, supra note 5, at 12. The Treadway Commission thus mandates that "audit committees should be informed, vigilant, and effective overseers of the financial reporting process and the company's internal controls." Id. at 41. Indeed, it was the implication for expanded audit committee responsibility that was probably regarded as the most significant aspect of the Treadway report. Certainly it was the most written about. See, e.g., McCauley & Burton, supra note 12, at A-1 (discussing the expansion of audit committees and their practical benefits); Ivan Bull & Florence Cowan Sharp, Advising Clients on Treadway Audit Committee Recommendations. J. Acct., Feb. 1989, at 46 (outlining ways to implement the recommendations of the Treadway Commission); Fraud Commission Recommends Quality Assurance, Audit Committees, 2 Corp. Couns. Weekly (BNA) No. 39, at 2 (Oct. 7, 1987) (reporting the findings of the Treadway report); Duane R. Kullberg, A New Stimulus to Fight Fraudulent Financial Reporting: How the Treadway Commission Has Strengthened the Audit Committee's Role, Directors & Boards, Fall 1987, at 21, 22 ("No single issue is more central to the Treadway recommendations than the need for a strong audit committee.").

43. See 3A James Solheim & Kenneth Elkins, Fletcher Cyclopedia of the Law of Private Corporations § 1146, at 348 (rev. vol. 1994) ("False representations as to the financial condition of the corporation, made by corporate officers, make[,] the officers participating in, or consenting to, the fraud liable to persons who are injured by reliance on the representations . . . ").
fulfill internal control responsibilities, they will be vulnerable to auditor accusations of misrepresentation arising out of negligence.\textsuperscript{44} For, in the wake of the discovery of fraud, the auditor will likely come to realize that the auditor has been deceived along with everyone else.

III. \textbf{The Evidence and the Law}

A. \textit{The Evidence}

Now it is time for the litigators. And to the frustration of officers and directors, they may find to their horror that, to the extent they have not fulfilled their financial reporting responsibilities, an evidence trail has already been laid suggesting some degree of senior-level and board-level liability to the auditor.

Foremost in this evidence trail will be the audit "representation letter." This is the letter signed by senior officials, typically the CEO and/or the CFO, in which they represent to the auditor that all financial records and related data have been made available, that material transactions have been properly recorded, and that there have been no irregularities involving management or internal control personnel.\textsuperscript{45} Where financial fraud surfaces, one or more of these representations turn out to be false. The first thing that happens, therefore, is that these representations, and the basis for them, are immediately called into question and the signing officials are potentially vulnerable for misrepresentation to the auditor.

Vulnerability does not, though, stop with the one or two officials who signed the letter. Typically the entire board of directors, and certainly the members of the audit committee, will be aware of the representation letter and its contents. Indeed, a set of "Good Practice Guidelines for the Audit Committee" places upon the audit committee responsibility for personal review of the representation letter and inquiry into aspects relevant to its representations.\textsuperscript{46} So now the audit committee, and for that matter the entire board of directors on whose behalf the committee was acting, may share some responsibility for written representations that were demonstrably false. The defense of truth being unavailable, the directors may be reduced to arguing ignorance, diligence, or that their motives were pure.

Their vulnerability can be exacerbated by the newly-revised contents of the audit report itself. As mentioned above, the responsibility of management for the audited financial statements is no longer implicit in the typical report. Now it is explicitly and prominently set

\begin{itemize}
\item \textsuperscript{44} See \textit{In re} The Leslie Fay Cos. Sec. Litig., No. 92 Civ. 8036 (WCC), slip op. at 42 (S.D.N.Y. Mar. 5, 1996) ("We conclude that [the auditor] has sufficiently alleged conduct on the part of the [directors] to support a claim for negligent misrepresentation.").
\item \textsuperscript{45} See AICPA Professional Standards AU § 333A.05 (1995).
\item \textsuperscript{46} Report of the National Commission, \textit{supra} note 5, at 181.
\end{itemize}
forth, in the first of three paragraphs, that, "[t]hese financial statements are the responsibility of the Company's management." While corporate officials may argue among themselves over precisely who constitutes "management," a normal jury may be less willing to engage in such hairsplitting.

An additional trail of evidence leading to the culpability of corporate officials may result from their prior approval of Forms 10-Q, 10-K, or other SEC filings, in draft or final form. Such documents may have been relied upon by the auditor as evidence of the good faith and well-founded belief of corporate officials as to the integrity of their content. Where their content turns out to be misstated, the adequacy of the official's diligence or, even worse, the extent to which the official may have known of the misstatement, can get called into question. If the officer or director knew, or had reason to know, of internal control issues compromising the integrity of the information disclosed, they may be liable to the extent the auditor justifiably relied upon it.

The trail of evidence may get worse. Recall that the national accounting firms have for the most part developed their own monographs, specifying a laundry list of audit committee responsibilities, which as a matter of practice they have handed out to audit clients. To the extent that corporate officials have not adequately undertaken to see that these responsibilities have been fulfilled, their vulnerability increases. If internal control issues have surfaced in the past, they may have been included in earlier "management letters," pursuant to which the auditor in prior audits may have described areas where the internal control system needed improvement. It is here, too, a senior management and board-level responsibility to see that suggestions in the management letters have been satisfactorily addressed. If the auditor has earlier described internal control structure "reportable conditions" or more egregious "material weaknesses," they should have been dealt with. If they have not been, and if the

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47. AICPA Professional Standards AU § 508.08 (1995).
48. "Reportable conditions" are defined as matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Id. AU § 325.02. Reportable conditions may involve aspects of the control environment, the accounting system, or control procedures. Id.
49. A "material weakness" in the internal control structure is defined as a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Id. AU § 325.15.
In the broadest sense, it is a typical aspect of state law that those familiar with material representations may to some extent be held accountable for their accuracy. Throughout the course of a normal audit, corporate representatives will have made any number of written or oral representations to the auditor, duly recorded by the auditor through notations in the audit workpapers. Here, too, a director of normal sophistication will know that such representations in the regular course will have been made. He or she may potentially be held accountable for their accuracy.

An important aspect of this evidence trail, moreover, is subtle but exceedingly important. Frequently, the corporate official's first line of defense to a misrepresentation claim will be a motion pursuant to Federal Rule of Civil Procedure 9(b) or its state law equivalent, which requires that fraud be pleaded with particularity. That means that the allegation of fraud generally must be accompanied by specificity as to precisely what was said, when, where, by whom, and how it was fraudulent. The strategic importance of this defense is that it can permit the corporate official to get out of the case at a preliminary stage on a motion to dismiss, rather than awaiting the rigors of the discovery process (in which something bad almost always turns up) and, horror of horrors, a trial. The evidence trail laid by a representation letter, SEC filings, and other such documentation may disarm the 9(b) defense.

50. In New York, for example, a claim for negligent misrepresentation exists where there has been "carelessness in imparting words upon which others were expected to rely and upon which they did act or failed to act to their damage," and the false information was "expressed directly, with knowledge or notice that it will be acted upon, to one to whom the author is bound by some relation of duty, arising out of contract or otherwise, to act with care." White v. Guarente, 372 N.E.2d 315, 319 (N.Y. 1977); see Brown v. Stinson, 821 F. Supp. 910, 914-15 (S.D.N.Y. 1993); Rotanelli v. Madden, 569 N.Y.S.2d 187, 188 (App. Div. 1991). "The gist of the action is fraudulently producing a false impression upon the mind of the other party; and if this result is accomplished, it is unimportant whether the means of accomplishing it are words or acts of the defendant, or his concealment or suppression of material facts not equally within the knowledge or reach of plaintiff." Noved Realty Corp. v. A.A.P. Co., 293 N.Y.S. 336, 341 (App. Div. 1937); see also In re The Leslie Fay Cos. Sec. Litig., No. 92 Civ. 8036 (WCC), slip op. at 41 (S.D.N.Y. Mar. 5, 1996) ("Under New York law, the [directors'] mere presence and participation at such meetings [with the auditor] could constitute sufficient conduct to support a claim for negligent misrepresentation, even if [the auditor] does not allege that the [directors] made any affirmative statements in support of any of the information presented to [the auditor] on which it was intended to rely . . . ."); O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 600 F. Supp. 702, 705 (S.D.N.Y. 1985) (under New York law, "silence alone may constitute a fraudulent act"); Minpeco, S.A. v. ContiCommodity Servs., 552 F. Supp. 332, 336 (S.D.N.Y. 1982) (conduct may be sufficient to constitute a false representation).

for this documentation may provide the requisite particularity. Putting aside guilt or innocence, the officer or director may be in the case for the long haul.

B. The Law

The prospect to an officer or director may be frightening, but the underlying legal basis for liability—largely untapped by the audit profession—has existed for years. A fraud to which every corporate official should be particularly sensitive, for example, arose out of the financial statements of Cenco Incorporated, a distributor of medical and health care products. The fraud at Cenco ultimately became the subject of three published opinions, one in the Seventh Circuit and two in the Northern District of Illinois. They warrant careful scrutiny.

What took place at Cenco was in many respects a classic fraud. It involved the corporation's chairman, its president, a number of vice presidents, other members of top management, and several members of the board of directors. The fraud was perpetrated primarily through the inflation of inventories, which in turn resulted in a higher stock price, enhancing the company's ability to make acquisitions. The outside auditor, Seidman & Seidman, failed to discover it. The fraud was ultimately uncovered when Cenco hired a new chief financial officer, who reported suspicions to the SEC. Rule 10b-5 litigation followed in which shareholders sued the company, management, and Seidman & Seidman; Cenco (now under new management) sued Seidman & Seidman; and Seidman & Seidman sued Cenco. At one point the melee spilled into the Seventh Circuit. The result was a decision by Judge Posner on what has become known as the "Cenco" or "imputation" doctrine—that a wrongdoing corporation whose senior management has engineered a fraud may not assert justifiable reliance on an otherwise-innocent outside auditor who failed to discover and expose it. The holding was significant in precluding a wrongdoing corporation from suing its auditor (or other professionals), and most courts, litigants, and scholars have focused on that aspect of the opinion and left it at that.

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54. Id.
55. Id.
56. Id. at 454-56.
unnoticed is what happened to Seidman & Seidman's claims against the company.

For what Seidman & Seidman did, as a strategic matter, was to settle with the class of shareholders for $3.5 million, and then to turn its sights on the company against whom it was making claims for breach of contract and fraud. In making those claims, Seidman & Seidman presented itself as a victim, setting forth in detail the extent to which it had been given fraudulent documentation by corrupt officials which, in turn, had caused it to get caught up in the shareholder litigation and, ultimately, to pay shareholders the $3.5 million settlement. The company, under the direction of its new management, responded that an outside auditor possessed no such claim and that Seidman & Seidman was in substance making a disguised claim for "indemnity," which as a matter of law was unavailable in a 10b-5 case. It was an argument that in subsequent years would appear again, and which is the subject of controversy to this day.

In Cenco, the Seventh Circuit held for Seidman & Seidman. In a part of the opinion that has been largely ignored by courts and litigants, the Seventh Circuit held that Seidman & Seidman could state a claim, separate from a claim for indemnity, for the company's fraud against Seidman & Seidman. The court explained:

[Indemnity is a remedy of one wrongdoer against another; and Seidman's claim is that it was a victim rather than a wrongdoer. It is


58. Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 451-52 (7th Cir. 1982).

59. Id. at 457-58.

60. Id.; see also Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1287-89 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970) (holding that there cannot be a claim for indemnification when the party seeking indemnification has committed reckless or willful criminal misconduct). Architects of class action settlements will appreciate the significance of an omission made during the Cenco settlement drafting process that resulted in the dispute. Pursuant to the settlement stipulation with the shareholders, Seidman & Seidman had been barred from asserting claims for "contribution" or "indemnification," but not from asserting other claims. Seidman & Seidman v. Cenco Inc., 601 F. Supp. 336, 338-39, 341 (N.D. Ill. 1984). Whether this was a conscious decision by the shareholders, or merely the result of a failure to recognize that independent claims might exist, is unclear from the record. In any event, no such claim having been barred, any independent claims would be permitted to proceed if they did exist as a matter of law (which the court held that they did).
true that it paid several millions to the class plaintiffs, but it never admitted wrongdoing or was adjudicated a wrongdoer. Therefore, if it can prove that Cenco defrauded it into issuing false audit reports which in turn exposed it to liability to the class plaintiffs, the amount it paid to settle with the class would be a permissible item of damages.\(^6\)

The result of *Cenco*, therefore, was that the company possessed no claim against the auditor. But the auditor did possess a claim against the company.

This struck Cenco’s new management as absurd, and it thereafter went back to the district court to try to convince it that the Seventh Circuit could not have meant what it said.\(^6\) In the district court, Cenco moved for summary judgment as to Seidman & Seidman’s claims, based on the proposition that Seidman & Seidman could not prove that the corporation had defrauded it and, moreover, that any such fraud had not been the proximate cause of Seidman & Seidman’s “voluntary” $3.5 million settlement.\(^6\) The district court, after reminding Cenco that it “undoubtedly must follow the holding of the Seventh Circuit and its enunciations of law,” held that an outside auditor under such circumstances could in fact have a claim.\(^6\) The court admonished that the real issue was “not whether Seidman voluntarily settled,” but whether the company’s fraud “was a cause of Seidman’s potential liability to the class.”\(^6\) If that were the case, then “Seidman’s settlement payment follows from that exposure and can be recoverable both under the opinion of the Court of Appeals above and Illinois law.”\(^6\) The auditor still had a claim, and the company still did not.

Management’s frustration only increased. Management thus mustered the courage to return to the district court again, on a renewed motion for summary judgment, now to persuade the district court that both the Seventh Circuit and the district court had gotten it all wrong.\(^6\) This time, the district court made clear that its patience was at an end. After chastising the corporation insofar as “[i]t wastes everybody’s time and the clients’ money to bring a summary judgment motion twice,”\(^6\) the district court spelled out in detail precisely why Seidman & Seidman’s claim was not a disguised claim for indemnity, but a separate claim that the auditor itself possessed. The court stated:

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63. *Id.* at 337-38, 341-42.
64. *Id.* at 341-42.
65. *Id.* at 342.
66. *Id.*
68. *Id.* at 540.
Contrary to Cenco's repeated arguments, there is a plain and common legal distinction between recovery via indemnification and via damages for a tort. . . . In the law, "recovery under principles of contribution or indemnity" is, quite simply, a different animal from "recovery under principles of direct tort liability." Waiver of the first is not necessarily waiver of the second. Indemnity generally, though not always, arises between two tortfeasors, and usually exists if a contractual or other relationship between the two warrants shifting one tortfeasor's entire liability to another tortfeasor. . . .

The gist of Seidman's fraud claim is not that it is more equitable that Cenco pay for Seidman's loss to the class, but that Cenco has committed a tort on Seidman, and must pay damages for this, damages which happen to encompass the settlement payment. That this element of damage overlaps what Seidman maybe could have recovered through indemnity does not make it indemnity. 69

As frustrating for officers and directors as the result may seem, there is much to be said for the analysis of the Seventh Circuit and district court in the Cenco trilogy. Insofar as the company had fed the auditor forged documents and false information upon which the auditor relied to its harm, the elements of a claim for misrepresentation appear to have been satisfied. Also apparently satisfied were the elements of a claim for breach of contract, insofar as the company was contractually obligated, pursuant to the terms of the audit engagement, to be honest with its auditor. These claims, moreover, were distinguishable from a claim for indemnification or, for that matter, contribution. Indemnification and contribution claims arise out of the breach of a duty separately owed by two wrongdoers to a common victim and an attempt by one wrongdoer to shift responsibility to the other. 70 An auditor's claim for misrepresentation or breach of contract, in contrast, arises out of the company's duty to the auditor to be honest. On a corporate-governance level, the Cenco trilogy implicitly accepts the fact, not to be explicitly set forth in the Treadway report until the next year, that determinedly corrupt management may with effort be able to defraud the outside auditor so that, if fraud is to be prevented at the outset, that prevention must take place within the corporation itself. It is the corporate governance version of "an ounce of prevention is worth a pound of cure."

In the Cenco litigation, management ultimately surrendered. The case was dismissed from federal court for lack of jurisdiction, 71 after which Seidman & Seidman filed claims for fraud and breach of con-

69. Id. at 541-42 (footnote omitted).


71. Cenco, 642 F. Supp. at 543.
tract in state court. As Seidman & Seidman pressed the case to trial, management agreed to settle. The case ended with Cenco's successor paying Seidman & Seidman a confidential sum.

The implications for class action litigation are significant. Not only may the officers and directors find themselves liable to shareholders. They may find themselves separately liable to their own auditor. The damages may include whatever expenditures the auditor may proximately attribute to its reliance upon the misrepresentations made. Such damages may potentially include harm to the auditor's reputation for being mixed up in the litigation to begin with; damages resulting from the distraction of professional personnel; costs associated with the litigation; attorneys' fees; even, as in Cenco, the amount of money paid to settle the shareholder claims. In the context of shareholder claims based on fraud, these damages can be somewhere between significant and astronomical.

In the years following the Seventh Circuit's decision in Cenco, at least six federal courts have either explicitly or implicitly accepted aspects of its analysis. Most recently, the United States District Court

72. See Robert D. Ready, The Auditor's Protection Against Liability Based on Clients' Fraud, 16 Bus. Law. 1039, 1052 (1961) ("Where the auditor suffers a financial loss or a loss of reputation as a result of suits for a failure to discover defalcations or irregularities, he is not without a remedy. If the defalcations or irregularities are management sponsored, he has an action for fraud against the client."); see also Enzo Biochem, Inc. v. Johnson & Johnson, No. 87 Civ. 6125(KMW), 1992 WL 309613, at *16 (S.D.N.Y. Oct. 15, 1992) ("[P]laintiff has provided sufficient evidence to prove the existence of a material fact regarding whether plaintiff was 'seriously injured in its business, property, goodwill and reputation' as a result of defendants' alleged negligent misrepresentations."); Kennedy v. McKesson Co., 448 N.E.2d 1332, 1333 (N.Y. 1983) (sustaining claim for damaged reputation based on, among other things, failure to inform plaintiff of important information).

73. See, e.g., In re The Leslie Fay Cos. Sec. Litig., No. 92 Civ. 8036 (WCC), slip op. at 37 (S.D.N.Y. Mar. 5, 1996) ("BDO does not simply seek indemnification for its attorneys' fees. BDO has identified other harms that it has suffered due to [the directors'] alleged negligent misrepresentation in connection with this lawsuit."); Alexander Grant & Co. v. Tiffany Indus., Inc., 770 F.2d 717, 718-19 (8th Cir. 1985) ("Grant, a public accounting firm, alleges that it was injured as the result of a pervasive scheme of mail and wire fraud designed by Tiffany to obtain a favorable audit for the fiscal year 1977 . . . . Grant has standing to assert its claims."); cert. denied, 474 U.S. 1058 (1986); Coopers & Lybrand v. Shapiro, No. 92-1938, slip op. at 14-16 (W.D. Pa. Jan. 11, 1993) ("[Coopers & Lybrand] contends that Shapiro, in his position as Chief Executive Officer and Treasurer of Phar-Mor, had a duty to supervise the other defendants, to verify that the statements made by him and others in the comfort letters were accurate, and to take steps to ensure that the statements were in fact accurate. . . . [T]he motion to dismiss . . . will be denied at this stage of the proceedings."); In re Sunrise Sec. Litig., 793 F. Supp. 1306, 1321 (E.D. Pa. 1992) ("This case is similar to In re Cenco."); Alvarado Partners, L.P. v. Mehta, 723 F. Supp. 540, 554 (D. Colo. 1989) ("[S]uch claims are independently viable pendent claims."); In re Wedtech Corp., 87 B.R. 279, 287 (Bankr. S.D.N.Y. 1988) ("The Cenco court . . . understandably drew a distinction between the indemnity and tort claims."); cf. Cullen v. Riley, 957 F.2d 1020, 1033 (2d Cir. 1992) (holding that "although judgment reduction compensates a nonsettling defendant for his lost rights of indemnity and contribution, it does not necessarily compensate him for other lost claims").
for the Southern District of New York relied upon Cenco to permit BDO Seidman, LLP to state claims against corporate officers and directors in connection with the fraud at The Leslie Fay Companies, Inc. Still, the acceptance of a Cenco analysis has not been entirely without resistance, or at least confusion. That has particularly been the situation where the underlying concepts of audit testing and

75. In Comeau v. Rupp, 762 F. Supp. 1434, 1440 (D. Kan. 1991), a Kansas district court said it was "thoroughly unpersuaded by the Accountants' attempt to cast their claims for indemnity as 'independent claims for relief.'" The history of the pleadings in the case may have contributed to that result. Though the record is not completely clear, it appears that the auditors in Comeau may have initially pleaded "indemnity" claims and then, in response to a motion to dismiss, "del[e]ted any reference to 'indemnity'" and instead simply characterized their claims "as 'independent claims for relief.'" Id. at 1438 n.4. The court concluded that the auditor claims were "part and parcel of their claims for indemnity," apparently based in part on the fact that the auditors' alleged damages in Comeau were "entirely dependent upon any liability that may attach to the Accountants for the claims made against them." Id. at 1440.

The claims alleged in Comeau were thus distinguishable from the claims focused upon by the Seventh Circuit in Cenco, insofar as the Cenco damages were not contingent upon recovery against the auditor; the Cenco damages were separate and assumed no auditor wrongdoing. See Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 458 (7th Cir.), cert. denied, 459 U.S. 880 (1982) ("It is true that [Seidman & Seidman] paid several millions to the class plaintiffs, but it never admitted wrongdoing or was adjudicated a wrongdoer. Therefore, if it can prove that Cenco defrauded it into issuing false audit reports which in turn exposed it to liability to the class plaintiffs, the amount it paid to settle with the class would be a permissible item of damages."). The Comeau court cited to Cenco, but perhaps misinterpreted it as dealing with a modified form of the defense of contributory negligence in malpractice actions against accountants. See Comeau, 762 F. Supp. at 1440 n.6. Somewhat cryptically, the court, immediately after citing Cenco, said, "The court restricts its discussion in this order to the cases and the policy considerations relied upon by plaintiffs and expresses no view at this time as to the merits of this modified approach." Id. A fair inference is that the situation in Comeau, perhaps owing in part to the history of the pleadings, was somewhat confused. See also Cortec Indus., Inc. v. Sum Holding L.P., No. 90 Civ. 0165 (CSH), 1994 WL 722708, at *5 (S.D.N.Y. Dec. 30, 1994) (declining to find an auditor claim because the auditor's "allegations of duties owed to it by these parties are conclusory and unsupported by pertinent authority"); Greene v. Emersons Ltd., No. 76 Civ. 2178 (CSH), 1985 WL 1989, at *2 (S.D.N.Y. June 28, 1985) (declining to find an auditor claim based in part on the "American Rule" against fee shifting); Greene v. Emersons, Ltd., [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,582, at 97,271-72 (S.D.N.Y. Dec. 1, 1983) ("I am not in a position to determine whether or not Leventhal is actually in a position to assert provable damages separate and apart from its potential liability to the plaintiffs."). The latter three decisions are discussed below.

76. For example, one leading text describes the holding of Cenco as being "that an accounting firm could seek common-law indemnity from a fraudulent client for $3.5 million paid to settle a dispute with stockholders." Denzil Y. Causey, Jr. & Sandra A. Causey, Duties and Liabilities of Public Accountants 203 (5th ed. 1995). The Cenco court did not, however, hold that the auditor could seek "common-law indemnity"; in fact, the court held that the auditor could not. Cenco, 686 F.2d at 457 ("[I]ndemnification from a co-defendant . . . is not allowed in a Rule 10b-5 case."). What the court held was that there was no indemnity claim, but that there was an independent claim for damages. Id. at 457-58.
responsibility for internal control systems have not been clearly understood. The result is illustrated by three unreported decisions spanning almost a decade (one of which was picked up by CCH), all by the same judge, which have at least two things in common. One is that they do not discuss, or cite, the analysis of the courts in Cenco. The other is that the analysis in each is horribly confused.

The first, decided about a year after the first Cenco decision, was Greene v. Emersons, Ltd.,77 in which the accounting firm Kenneth Leventhal & Co. was sued by shareholders based on the allegedly-misstated financial statements of a food service company. Leventhal asserted cross-claims against two corporate officials, including claims for "fraud," "conspiracy to violate legal rights," and "interference with business relations and inducing breach of contract."78 The corporate officials sought to dismiss the claims, characterizing them as improper claims for indemnity. Leventhal responded that it was setting forth independent claims resulting in "independent damage upon Leventhal."79

The case presented the court with a dilemma. On the one hand, the suggestion that the auditor might have independent claims against corporate officials plainly struck the court as intuitively wrong. On the other hand, the court recognized that the technical elements of a claim just might exist. To resolve the dilemma, the court punted. It observed that Leventhal had failed to specify the independent damages that it might have suffered and that the court was therefore "not in a position to determine whether or not Leventhal is actually in a position to assert provable damages separate and apart from its potential liability to the plaintiffs."80 The court deferred decision and ordered Leventhal to itemize its damages.81

That took care of the problem for another year and a half. But in mid-1985 the court, now faced with a particularized itemization by Leventhal, had to confront whether Leventhal did in fact possess separate claims.82 Unfortunately, the issue was confused by the fact that Leventhal's articulated damages were limited to "legal and related expenses arising out of this litigation."83 This led the court to agree with Leventhal that its claims were "not in any respect claims for indemnity," but nonetheless then to conclude that "[i]n a larger sense, Leventhal seeks indemnity by these crossclaims."84 This judicial leap

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78. Id.
79. Id. at 97,272.
80. Id.
81. Id.
83. Id.
84. Id.
from one conclusion to precisely the opposite was then confused further by the court's determination that what really involved was the issue of fee-shifting, since Leventhal's measure of damages involved expenses arising out of litigation. This drew the court to then take up the issue in terms of the "American Rule" against fee-shifting, which in fact had nothing to do with it, pursuant to which each party must bear its own litigation expenses. The court found that, pursuant to the "American Rule," no such shifting on an indemnity claim was to be allowed.

85. Id.
86. The American Rule against fee-shifting involves shifting litigation expenses from the loser to the winner in the litigation between them. See Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 247 (1975); United States v. 110-118 Riverside Tenants Corp., 5 F.3d 645, 646 (2d Cir. 1993). The issue presented by Leventhal, in contrast, did not involve the shifting of fees between Leventhal and the corporate officials based on Leventhal's success or failure on its cross-claims. Rather, it involved Leventhal's recovery of litigation expenses incurred in defending the separate shareholder claims. In other words, the issue presented by Leventhal's claims did not involve the shifting of fees between the winner and the loser in the pending litigation, but the auditor's recovery of litigation expenses incurred in a separate litigation (or as to separate claims) with a different party.

To be fair, it is unclear the extent to which the issue was framed in terms of fee-shifting by the parties, rather than by the court. And the analysis was complicated by the fact that the damages sought by Leventhal were limited to "legal and related expenses"—excluding, for example, the settlement costs that were at issue in Cenco.

87. Id. at *2. The court reached this conclusion by determining that the so-called "tort-of-another" exception to the American Rule against fee-shifting did not apply. The court's conclusion here too is questionable, insofar as an auditor who gets mixed up in litigation as a result of management fraud would seem to qualify squarely as one who, in the words of the Restatement, "through the tort of another has been required to act in the protection of [its] interests by bringing or defending an action against a third person." Restatement (Second) of Torts § 914(2) (1977). Such a person, according to the Restatement, "is entitled to recover reasonable compensation for loss of time, attorney fees and other expenditures thereby suffered or incurred in the earlier action." Id.; see Shindler v. Lamb, 211 N.Y.S.2d 762, 765 (Sup. Ct. 1959) ("If, through the wrongful act of his present adversary, a person is involved in earlier litigation with a third person in bringing or defending an action to protect his interests, he is entitled to recover the reasonable value of attorneys' fees and other expenses thereby suffered or incurred.").

This tort-of-another rule did not apply, the court held, because the pleadings included "claims arising out of Leventhal's own alleged wrongdoing" and, according to the court, "[w]hat controls is the plaintiffs' pleading," rather than the ultimate outcome of the case. Greene, 1985 WL 1989, at *1-2. This rationale actually makes little sense. Wrongful involvement as a defendant in litigation will always be premised upon some allegation of the defendant's wrongdoing, so the court's exception to the tort-of-another claim would swallow the rule. The result of the court's analysis, moreover, would be that the assertion of even an unmeritorious claim of wrongdoing could unilaterally deprive the tort-of-another plaintiff of an otherwise viable claim against the defrauders. The court's decision was also contrary to the conclusion of the Seventh Circuit in Cenco, in which the court of appeals held that the extent to which Seidman & Seidman possessed a claim against the company should be determined as a matter of proof rather than pleading. Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 458 (7th Cir. 1982) ("Therefore, if it can prove that Cenco defrauded it into
One may sympathize with this court. The issues can be confusing, made all the more so in this case because the damages were limited to litigation expenses. What in fact happened is that the court was mixing up three separate claims without realizing that each should have been dealt with separately. The court started with independent tort claims by Leventhal; then leapt to the conclusion that Leventhal was really seeking indemnity; then leapt to the conclusion that the indemnity claim really involved the rule against fee-shifting, which then guided the court down the wrong legal path to a jumbled conclusion. It is small wonder that the court's intellectual struggle emerges so vividly from the decision.

Alas, the court was still not free of the issue. Nine years later, the independent claim issue reared its ugly head again, this time regarding an audit by Ernst & Young in Cortec Industries, Inc. v. Sum Holding L.P.\textsuperscript{88} In Cortec, the court was faced with a "tort-of-another" claim by Ernst & Young which, the court suggested, turned on the existence of an independent auditor claim against the tort-of-another defendants. The court took a step closer to the analysis in Cenco, implicitly acknowledging the possibility of an independent auditor claim. But it held that Ernst & Young's allegation was not specific enough and lacked authority: "Ernst & Young's allegations of duties owed to it by these parties are conclusory and unsupported by pertinent authority." Here, again, the court neither discussed nor cited any of the Cenco cases in its decision. Nor did the parties, who were directing their attention to the tort-of-another claim alleged in the complaint, discuss or cite Cenco in their briefs.\textsuperscript{89}

What largely appears to have guided the court to its conclusion in this third case was a basic misunderstanding of the auditor-client relationship. An independent auditor, the court stated, "is retained to pass competent professional judgment upon the accuracy of corporate financial statements and to issue such related documents as comfort letters."\textsuperscript{90} The court continued:

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issuing false audit reports which in turn exposed it to liability to the class plaintiffs, the amount it paid to settle with the class would be a permissible item of damages.
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\textsuperscript{88} No. 90 Civ. 0165 (CSH), 1994 WL 722708 (S.D.N.Y. Dec. 30, 1994).

\textsuperscript{89} Id. at *5. The Eleventh Circuit reached a more understandable outcome, though under different facts not involving an auditor, in \textit{In re U.S. Oil & Gas Litig.}, 967 F.2d 489 (11th Cir. 1992). In that case, an insurance company tried to assert purportedly "independent" claims against an insurance broker and another. \textit{Id.} at 491, 495-96. Though labeled as independent state law causes of action for fraud and negligence, the substance of the allegation was that the insurance company sought "damages... to the extent that it is liable to any of the plaintiffs herein." \textit{Id.} at 496. The Eleventh Circuit had no difficulty concluding that "a rose by any other name is still a rose," and held that the purported fraud and negligence claims were "nothing more than claims for contribution or indemnification with a slight change in wording." \textit{Id.} at 496 (quoting S.C. Nat'l Bank v. Stone, 749 F. Supp. 1419, 1433 (D.S.C. 1990)).

If an auditor, in the performance of those tasks, acts fraudulently, recklessly, or negligently, it has breached its own professional duties, and cannot transform those breaches into, or mask them behind, breaches of duties allegedly owed to the auditor by the keepers of the books the auditor was retained to audit.91

The problem with this rationale is that an auditor who has been defrauded is not trying to "transform" audit inadequacies into "alleged" breaches of duties owed by corporate management. Corporate management in fact owes a duty, which is an explicit underpinning of GAAS, not to defraud the auditor.92 Where that duty to the auditor is breached, it is entirely possible that the auditor will not detect the fraud, notwithstanding the auditor’s lack of negligence and complete conformity to GAAS, particularly where the fraud has been directed against the auditor itself.93 At a minimum, the possibility of an absence of auditor wrongdoing suggests that the auditor should be permitted to plead a claim, rather than in essence being adjudged a wrongdoer based solely on the pleadings. Even where the auditor is negligent, moreover, the court’s conclusion presents some rather basic problems in terms of rudimentary precepts of justice. One is that, under the court’s analysis, in a litigation between a negligent auditor and a deliberately-defrauding corporate official, the defrauder wins.

One of the most fundamental problems with the Cortec court’s analysis, though, is that it is contrary to the allocation of responsibility articulated by the Treadway Commission. The Treadway Commission, recognizing that financial fraud most frequently originates with senior corporate officials and the inadequacy of internal control systems, places primary responsibility for the prevention of financial fraud upon senior management and the board of directors through its audit

91. Id.
93. The Professional Standards provide:
   .07 Because of the characteristics of irregularities, particularly those involving forgery and collusion, a properly designed and executed audit may not detect a material irregularity. For example, generally accepted auditing standards do not require that an auditor authenticate documents, nor is the auditor trained to do so. Also, audit procedures that are effective for detecting a misstatement that is unintentional may be ineffective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client.
   .08 The auditor should exercise (a) due care in planning, performing, and evaluating the results of audit procedures, and (b) the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected. Since the auditor’s opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and his report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement exists in the financial statements does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the auditor.

Id. §§ 316.07 to .08.
committee. To the extent such corporate officials are relieved of liability, the incentive to fulfill these internal control responsibilities diminishes. Nor does the auditor, whose responsibilities would correspondingly increase, possess the ability to substitute adequately for such management failings. While an auditor may in some instances be able to detect forged documents or other false evidential matter through audit testing, the auditor does not possess the power or the authority to prevent such improprieties before they occur. As a matter of corporate governance, that prevention is strictly within the purview of the senior officers and directors. It is foreseeable that future decisions will conclude that the weight of authority, both in terms of volume and in terms of intellectual justification, resides with the Seventh Circuit’s analysis in Cenco.

IV. SETTLEMENT PROBLEMS

For corporate officials, the existence of auditor claims carries with it important procedural and strategic considerations beyond the potential exposure to the auditor for damages. The reason is that, as widely known, the overwhelming number of shareholder actions are resolved not through trial, but through settlement. The existence of auditor claims can make a negotiated settlement difficult.

Ideally, in the context of settlement, the issue of independent auditor claims would not even come up. The preferred settlement is one in which all parties come to terms, a settlement stipulation is signed, everyone releases everyone, and the result is global peace. With some frequency, however, the ideal solution is not reached. It is sometimes the case that shareholders will be prepared to settle with corporate officials for a relatively modest sum, with the expectation of seeking substantially more money from the deep-pocket auditor, who therefore declines to settle. Even here, corporate officials may nonetheless expect to get “global peace,” at least for themselves, through the court’s entry of a “settlement bar order” which precludes auditor cross-claims for contribution and indemnification back against the corporate officials.

The problem is that such a settlement bar order, upon which the corporate officials would rely for global peace, may not properly preclude noncontribution or nonindemnification claims. In other words, independent auditor claims, to the extent they exist, may proceed against the settling corporate officials unimpeded. The corporate officials, thinking they have bought global peace by striking a deal

94. See Cullen v. Riley, 957 F.2d 1020, 1033 (2d Cir. 1992) ("[A]lthough judgment reduction compensates a nonsettling defendant for his lost rights of indemnity and contribution, it does not necessarily compensate him for other lost claims. Accordingly, we conclude that this overly broad settlement bar might impermissibly affect Riley's rights and thus cannot stand.").
with shareholders, can find themselves brought right back into the lig-
igation by the auditor.

This is precisely what happened, for example, in one of the district
court cases following *Cenco*, involving the failure of a Florida savings
and loan. In *In re Sunrise Securities Litigation*, shareholders and the
FDIC sued, among others, a law firm and the accounting firm
Deloitte, Haskins & Sells. The law firm did not have the stomach
for the fight, and entered a settlement stipulation with both the share-
holders and the FDIC. The settling parties, as is standard in such situ-
ations, sought and obtained from the district court a “settlement bar
order,” providing for the dismissal with prejudice of all contribution
claims against the law firm and ordering a proportionate reduction in
the damages to be paid by the remaining nonsettling defendants.

The law firm apparently believed that, having paid its money, it had
bought global peace and had completely terminated its involvement in
litigation.

That turned out to be wrong. Once the law firm had settled, it then
found Deloitte pressing forward with independent auditor claims
based on principles of state law tort and contract. The law firm
dashed back to the district court to seek enforcement of the district
court’s settlement bar order. In particular, the law firm sought a rul-
ing that Deloitte’s state law tort and contract claims (along with cross-
claims by other parties) were “de facto indemnity claims,” and that
the law firm was therefore protected from any further litigation by the
earlier-procured settlement bar order.

It did not get that ruling. Instead, the court found that the in-
dependent claims could continue to be prosecuted against the settling
law firm because they were left unaffected by the bar order. For sup-
port, the court relied upon the Seventh Circuit’s decision in *Cenco*.
The court stated:

This case is similar to *In re Cenco*. The damages that the non-
settling defendants seek for their tort and contract claims are simi-
lar, although not identical, to the damages that they seek for their
indemnification claims. Such an overlap does not necessarily trans-
form the claims into claims for implied indemnity. The state law
cross-claims which the Outside Directors and Deloitte have asserted
against [the law firm] are based upon duties that it allegedly owed
to the outside Directors, not duties that they and [the law firm]
owed to the plaintiffs. Specifically, the various non-settling defend-
ants allege that [the law firm] is liable to them for intentional mis-
representation, negligence, breach of contract, and tortious

96. See id. at 1309-10.
97. Id.
98. Id. at 1321.
99. Id.
interference. They claim that they were directly wronged by [the 
law firm].

The same thing happened in another case involving Deloitte, this 
one arising out of shareholder litigation in connection with a com-
puter software company. In *Alvarado Partners, L.P. v. Mehta*, the 
shareholders settled with the company and certain directors among 
others, but not with Deloitte. The settling shareholders and directors, 
again in accordance with the normal practice, signed a settlement stip-
ulation and then went before the district court to obtain a settlement 
bar order against, among other things, any state claims by Deloitte. 
Here, too, they were unsuccessful. The court held that, to the extent 
Deloitte or the other nonsettling defendants sought damages "mea-
ured by . . . liability for violation of the Securities and Exchange 
Acts," those claims could be "extinguished." But, the court cau-
tioned, to the extent such claims were "independently viable pendent 
state claims," they were left unaffected by the settlement bar order:

[T]o the extent damages may be claimed beyond those sought for 
violation of the Securities and Exchange Acts, such claims are inde-
pendently viable pendent state claims, and while, in my discretion, I 
may decline to exercise pendent jurisdiction, I may not "extinguish" 
them.

The settling parties' motion for an order approving the partial settle-
ment plan was denied.

100. *Id.*
102. *Id.* at 554.
103. *Id.* (citations omitted). At least one case, though involving different circum-
stances, raises the possibility that any attempt to extinguish independent auditor 
claims through a settlement bar may be unconstitutional. In *County of Los Angeles 
v. Superior Court*, 202 Cal. Rptr. 444 (Ct. App. 1984), a construction company, hired 
by a county to build the foundation for a public building, brought an action against 
the county and the architect which designed the building, alleging that it had lost 
money because the architect's plans were defective. The county cross-claimed against 
the architect for breach of contract. The architect then settled with the plaintiff con-
struction company, and sought to use that settlement to bar the county's cross-claims. 
A California trial court held that the county's cross-claims were barred. *Id.* at 445-46.

The California Court of Appeal reversed. The county's claims against the architect, 
the Court of Appeal held, were based on a separate duty owed to the county by the 
architect as a result of the contractual relationship between them. Claims based on 
conduct in connection with a duty owed to the county by the architect, whether based 
on contract or even if "viewed as professional negligence, ergo tortious," were left 
unaffected. *Id.* at 447. Moreover, according to the court, this result was mandated by 
the California Constitution. The court found that bar of a direct claim for breach of 
contract would amount "to a violation of California Constitution Art. I, section 9 
prohibiting the impairment of obligations of contracts." *Id.*
104. *Alvarado*, 723 F. Supp. at 554. One unreported case deals with independent 
claims with an ironic twist. See *In re Alert Income Partners Sec. Litig.*, No. MDL-915, 
slip op. (D. Colo. Mar. 17, 1994). In that case, shareholders commenced litigation 
against the officers and directors of a series of failed limited partnerships as well as 
against the outside auditor. Ironically, though, here it was the auditor that entered a
V. What To Do?

What's an officer or director to do? At the risk of stating the obvious, the best alternative in the first instance is to study the recommendations of the Treadway Commission and to do one's best to live up to them. Implementing guidance has, subsequent to publication of the Treadway report, been published by the so-called Committee of Sponsoring Organizations of the Treadway Commission, known as COSO, which analyzed at length the internal control structure of companies and proposed specific steps to ensure internal control structure integrity.

Foremost on the list of any official's tasks will be the retention of honest management and the installation of a "tone at the top" in the corporate culture that strives to the utmost for honest financial reporting and complete integrity and objectivity in the financial reporting process. Complementing an appropriate "tone at the top," corporate officials will want an "informed, vigilant, and effective" audit committee whose members actively oversee the financial reporting process and the company's internal controls. Below the senior-executive level, corporate officials will want to ensure that their internal accounting systems, as a matter of corporate personnel, logistics, and desire, are systematically capable of adhering to financial reporting goals. A policing mechanism can be implemented through the insistence upon open channels of communication and the development of an independent and zealous internal audit department, which has the authority to police and investigate the financial reporting systems and to report with candor directly to the board of directors or its audit committee. Probably ninety-nine percent of the boards of directors

settlement and one of the officials who declined to. The court held that any independent claims by the official were not barred. The court stated:

If the damages are measured by the non-settling defendant's liability to plaintiff on claims that the plaintiff has already settled with other defendants, then the cause of action is actually a contribution claim and is barred. If, on the other hand, the damages are measured differently, the cause of action is not barred.

Id. at 2. On the record at issue, the court stated that it was "unclear" whether the claims at issue were "independent claims or disguised requests for indemnification and contribution." Id. at 3.


107. In one form or another, many of these concepts can be found in a number of popular management texts that have appeared over the last several years. One especially well received book that, consciously or not, explicates the internal control concepts underlying the Treadway report, and in particular the dangers posed by a misalignment of measurements and rewards, has been written by the Director of the W. Edwards Deming Center for Quality Management at the Columbia Business School. See John O. Whitney, The Trust Factor: Liberating Profits & Restoring Corporate Vitality (1994).
in America would insist that they have already attained such goals. The true percentage is probably significantly less.

None of this is to suggest, of course, that a corporate officer or director will necessarily be liable to the auditor solely because a financial fraud has occurred. Liability turns not on the mere existence of misstated financial statements, but on participation in the misstatement or on a demonstrable failure on the part of corporate officials to exercise an appropriate level of diligence in the fulfillment of their financial reporting responsibilities. The required level of diligence will necessarily vary with the corporate official’s role in the organization—whether it be, for example, as an officer, a member of the audit committee, or a purely outside director. Where corporate officials have fulfilled their responsibilities, liability should not and will not follow. And if the outside auditor in such an instance has failed to fulfill its professional responsibilities, then the outside auditor may very well be liable for the harm thereby caused.108

If fraud does occur and shareholder litigation against officers and directors results, a critical consideration is the difficulty of a resolution that does not involve the auditor. It is useful, therefore, to keep the class action settlement contingent upon the absence of all auditor claims, so that the officer or director does not find him- or herself in the unfortunate position of being required to finance the settlement while still being exposed to further litigation and damages.

108. It is not unusual for an officer or director under such circumstances to consider an allegation that, like the shareholders, he or she was also relying upon the audited financial statements, though, in the absence of a demonstrable factual predicate, experienced trial lawyers may counsel against it. The problem with such an allegation is that, even where it can be pleaded, it can be surprisingly difficult to prove, given the access of corporate officials to more frequent and direct financial data than financial statements that do not appear until months into the following year.

A case in the Supreme Court of the State of New York illustrates the difficulty. Effron v. Peat Marwick Main & Co., N.Y. L.J., Apr. 20, 1994, at 21-22 (N.Y. Sup. Ct. Apr. 19, 1994). The case included claims by officers and directors that they had been damaged by their reliance on financial statements audited by a Big Six firm. At trial, the breadth of the jury was illustrated by two jurors who, for purpose of consideration of such a claim, seemed complete opposites—a commercial banker whose day-to-day activities involved financial analysis, and an unemployed former laundromat worker. By the close of plaintiffs’ case, these two very different jurors had at least one thing in common: neither accepted the testimony of the corporate officers and directors that they had relied upon the financial statements. Both pointed to the officials’ access to much more direct and current information, and called upon their own life experiences in rejecting the reliance allegation. The banker, subsequent to trial, spoke of the need of corporate officials to be much more attentive to financial performance than would be permitted by the annual review of financial statements. The unemployed laundromat worker called to mind her experience in collecting the coins out of laundromat washing machines as illustrative of her view that you have to pay close attention to a business, rather than relying upon once-a-year statements of performance. Cf. Frymire-Brinati v. KPMG Peat Marwick, 2 F.3d 183, 191 (7th Cir. 1993) (observing that the plaintiff director “may have considerable difficulty persuading a jury that hears all of the evidence . . . that she reasonably relied on Peat Marwick’s certification of the 1983 financial statement”).
Conclusion

The prospect of corporate officials being liable to their outside auditor does not suggest that, in every financial fraud case, corporate officials and the auditor need be at each other’s throats. In many or most cases, strategic considerations will yield the conclusion that both are better off presenting a united front against the class action lawyers rather than dividing their forces and seeking to make out fraud claims against each other. Still, it is obviously useful for officers and directors to understand fully their financial statement responsibilities and vulnerability. And if a by-product of that is the improvement of the systems of corporate governance, all the better.