LIMITING LIABILITY TO ESCAPE ACCOUNTABILITY: A COMPARATIVE ANALYSIS OF AUDITORS IN THE USA AND NIGERIA

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Abstract
The auditing profession is saddled with a crucial role in financial markets. Auditors are the independent third parties that assure regulators, creditors, and investors about the accuracy of financial statements and whether such statements represent the accurate and fair view of the company's financial position. However, when auditors fail in undertaking this responsibility, as seen in cases of Enron in the United States and Cadbury Nigeria Plc's overstating its financial statements, such failures can provoke a monumental financial and reputational damage that would undermine market stability and deplete public trust. Often, investors sue auditors for financial loss due to relying on the erroneous financial statements. In the face of this reality, auditors have increasingly called for legal reforms to limit their liability and save them from an existential threat. This article examines auditor liability legal and regulatory regimes in Nigeria and the United States. It analyses recent developments, and evaluates the legitimacy of liability limitation efforts. It proposes that while a degree of liability protection is necessary, it must not be used to avoid responsibility for professional failure.

Keywords: *Auditors, Liability caps, Nigeria, United States*

1.0 Introduction: Towards a Liability Gap

Audit liability has recently become an increasing concern for the auditing profession. In a flurry of activities following Enron's spectacular disintegration, the profession has witnessed significant transformation of its market structure, expansion in its duties vis-à-vis public companies, and the creation of a new regulatory oversight apparatus, especially in the US.[1] As is usual with financial turmoil, this exacerbated the longstanding polemic about the public's discontent with the actual nature and scope of audit work.[2] Rather than improving audit quality, the audit profession countered with claims about an inequitable reliance on auditors' deep pockets. These facts, coupled with large claims and the escalating cost of indemnity insurance cover, provoked a great deal of lobbying by firms for changes in the law to limit their liability exposure, an exposure that some claim threatens the very viability of the industry. They aver that outmoded corporate liability laws have made them disproportionately liable for a company's financial negligence, and that a major class action suit could vaporise another global accounting firm, even with a minor contribution

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[1] Thus, for example, while the *Private Securities Litigation Reform Act of 1995* (PSLRA) shifted to proportionate from joint liability for auditors, the *Sarbanes-Oxley Act* imposes new demands on auditors that increase liability risk, including through new audits of internal control over financial reporting.

[2] Anastassia Samsonova, *Re-thinking Auditor Liability: The Case of the European Union's Regulatory Reform* (2010) 2 http://apira2010.econ.usyd.edu.au/conference_proceedings/APIRA-2010-241-Samsonova-Re-thinking-auditor-liability.pdf accessed 7 May 2025.

to the company's problem. Some reforms in the US have permitted limiting auditors' liability, but the Nigerian Companies and Allied Matters Act 2020 (CAMA) does not impose joint liability on auditors unless proven in court. However, US case law, such as *Ultramares Corp v Touche,* has long protected auditors from third-party suits without privity.[3] However, some quarters are concerned that the auditing industry is campaigning for liability concessions to protect itself from possible lawsuits resulting from its failures. Thus, the industry is responding to an expanding expectation gap by filling the liability gap.

2.0 Policy Debate over Catastrophic Risk to Auditors

Increased market capitalisation of companies during the last decade has significantly increased the risk of auditing such companies. At the same time, auditors' access to insurance has fallen sharply, especially for firms auditing international and listed companies, thus leaving partners in audit firms with an unattractive prospect of entirely bearing the liability risks themselves. This situation has inspired academic and professional debate over the equitable nature of auditor liability and the potential risk that a successful lawsuit against the auditors could serve to bring down one of the major audit firms. A hard call indeed for politicians and regulators alike against the backdrop of a financial crisis that is yet to abate; with prominent Wall Street firms collapsing and disappearing, almost overnight; the federal government engaged in serial bailouts of financial troubled institutions; and the recent passage by the US government of a financial reform that essentially toughens the regulatory oversight on the entire financial services industry.

In this volatile and changing landscape, proposals for liability reform have received scant attention from U.S. regulators, as the more pressing business of the "credit crunch" commanded their attention.[4] Having said that, although governments and regulators have had their attention diverted by a severe financial crisis that has gripped their economies, it is reasonable to argue that the debate over the fairness or otherwise of auditors' civil liability and the existential threat it poses to the audit profession is a continued and recurrent debate that is as old as the modern audit itself.[5] This fact is seen in two similar opinions that spanned about half a century apart:

> The problem confronting the profession is to see to it that the liability is 'clearly defined', and that the extent of damages bears some reasonable relationship to the gravity of the accountant's offence.[6]
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> We would not suggest that auditors should be freed from the threat of liability – as outlined earlier; exposure to liability is a driver of quality and should remain. But there needs to be some additional recognition of the fact that auditors do not 'guarantee' the accuracy of a company's accounts or the integrity of the underlying records and that, in some cases, auditors can and are deceived by

[3] 174 NE 441 (NY 1931)

[4] J Craig Dickey, 'Auditor Liability 'Caps'–The Politics of Catastrophe' (2008) 5 *Securities Litigation Report* 3.

[5] Christopher Humphrey and Anastassia Samsonova, 'A Crisis of Identity? A Juxtaposing Auditor Liability and the Value of Audit' in Roberto Di Pietra, Stuart McLeay and Joshua Ronen (eds), *Accounting and Regulation: New Insights on Governance, Markets and Institutions* (Springer 2014) 112.

[6] J L Carey, *The CPA Plans for the Future* (American Institute of Certified Public Accountants, New York 1965) 415.

> directors and management. We agree that auditors should be responsible for their own mistakes, but query whether they should be also held responsible for the failings, or wilful deceit, of other.[7]

As seen here, the audit profession has complained about the continued rise of litigation against its members by clients and other non-clients alike who have relied on their audit reports in making investment decisions.[8] However, the audit profession's detractors would retort that such activity only shows dwindling public confidence in auditors' ability to perform their duties properly.[9] The latter point of view may be substantiated by the two notable collapses directly linked with audit failure: Enron in 2001 and Lehman Brothers in 2008. The profession would, nonetheless, emphasise that these are isolated cases that do not reflect its general performance in the myriad other companies it audits. Moreover, the level of litigation they face is inequitable and untenable, and they claim that it presents a risk of Armageddon to the profession.[10] The US Treasury's Advisory Committee on the Auditing Profession (2008) has warned that unchecked liability exposure could destabilise the profession. The Institute of Chartered Accountants of Nigeria (ICAN) and other professional bodies in Nigeria have echoed similar arguments, emphasising the necessity of reform for companies to attract and retain auditors.

In support of their argument, the auditors have cited some record claims brought against them in recent memory, like the £2 in case of the British insurance company Equitable Life against Ernst and Young and the $1bn claim brought against KPMG for the audit of the failed New Century Financial, as good examples of the real existential threat the profession is faced with if such kinds of litigation were to succeed.[11] The auditing profession claims that the over-liability threat is underpinned by its desire to fight against what it considers an unfair regulatory policy behind the 'epidemic of litigation' it endures, i.e., joint-and-several liability, which is discussed below.[12]

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[7] J Davies, 'A Sharper Shield' (ACCA, 1 October 2014) https://www.accaglobal.com/gb/en/discover/ab-articles/audit-assurance/sharper-shield.html accessed 13 March 2015.

[8] R Di Pietra, S McLeay and J Ronen (eds), *Accounting and Regulation: New Insights on Governance, Markets and Institutions* (Springer 2014) 112.

[9] ibid

[10] ibid

[11] ibid

[12] Joint and several liability presupposes that if several parties are liable for damages, the claimant can choose to sue all of the parties or one of them for the whole loss suffered. Therefore, in the case of financial loss concerning errors in the financial statements, if both directors and auditors are liable for the loss sustained, the claimant may elect to sue the directors or auditors for the loss, irrespective of who may be more culpable. More often than not, auditors are sued and left to bear the full brunt of the damages awarded to the claimant, perhaps because auditors are best placed to pay because of their 'deep pockets.'

2.1 Joint and Several Liability: Liability Expansion

The doctrine of joint-and-several liability was initially developed at common law as two separate theories of liability.[13] The application of joint liability at common law was strictly limited, applying only to joint tortfeasors who had conspired or acted in concert. However, if the parties did not act in concert, the law would not permit joinder, and joint liability was disavowed.[14] Joint liability *stricto sensu* is originally related to issues of intentional torts because of the higher degree of intent involved in planning or acting in concert.[15] Accordingly, in an action for recovery of damages where a plaintiff was injured due to the acts of two or more tortfeasors who did not act in concert, the plaintiff may sue any or all of the parties individually and recover the damages. However, since they did not act in concert, the plaintiff cannot join all the parties in one suit during the early stage of the doctrine's development.[16] In addition, if the plaintiff recovers damages from one of the parties, he cannot proceed against the other defendants. For this reason, when filing their first claim, shrewd plaintiffs usually target defendants in a financially strong position to shoulder the damages.[17] These types of defendants came to be known as deep-pocket defendants.[18] Furthermore, since recovery could be obtained from any individual defendant irrespective of the defendant's degree of culpability, once the plaintiff recovers all of his or her damages in the first suit, he or she would not need to proceed further against the other defendants. This is an excellent strategy from a procedural law standpoint that is both time-saving and efficient.[19]

The early American cases followed the position of English courts in denying joinders, except in cases where the defendants acted in concert and a few other circumstances, like mutual responsibility for the same act. The American attitude was completely altered by the passage of the Field Code Act in 1848 in New York, where the law required joinder of all questions connected with one subject matter in a single suit. As the doctrine developed over time, so did its application by courts, allowing plaintiffs to join different defendants in a single suit so long as the harm produced by their separate negligent acts is indivisible, as in the case of *Smithson v Garth*.[20] Moreover, the plaintiffs were free to choose how they deemed expeditious to recover from the defendants, and one defendant had no legal right to seek contribution from other

[13] R Mednick and JJ Peck, 'Proportionality: A Much-Needed Solution to the Accountants' Legal Liability Crisis' (1994) 28 *Valparaiso University Law Review* 872 http://scholar.valpo.edu/vulr/vol28/iss3/3 accessed 7 May 2025.
[14] ibid 873.
[15] *Smithson v Garth* (1691) 3 Lev 324, 83 ER 711.
[16] (n 13) 872. Moreover, an action against one of the tortfeasors automatically bars any further action against the rest of the tortfeasors.
[17] ibid 873.
[18] ibid
[19] ibid
[20] (1691) 3 Lev 324, 83 ER 711. In this case the defendants acted in concert to rob the plaintiff, although one battered him, another imprisoned while the robbed him all were held jointly and severally because the cause of action was one.

defendants.[21] The practice of joining defendants who acted separately but whose actions created one indivisible harm gained notoriety among plaintiffs for its simplicity from a procedural standpoint. The concept of joint-and-several liability came to be enshrined as an integral part of the tort system.[22]

The challenges in apportioning liability led to contributory negligence, in which the plaintiffs must demonstrate to the court that they have not contributed to the damage they suffered.[23] The doctrine of contributory negligence was introduced to the US in 1824 via the Massachusetts case *Smith v Smith*.[24] The doctrine rapidly gained acceptance in nineteenth-century American jurisprudence, probably to protect America's young and growing industrial base, especially the railways. The doctrine functions as a penalty to deny recovery to the plaintiff for his lack of care.[25] Usually, once the court decides that the defendants were negligent, the next question is how much damage the defendants should collectively pay, rather than the individual defendant's degree of culpability.[26] It is poignant to point out that some states in the United States eventually adopted the concept of "comparative liability" to alleviate the excesses of joint-and-several liability. Pursuant to the application of "comparative liability", the percentage of the individual defendant's fault was used to determine the amount he paid, known as comparative contribution. This rule apart, each defendant is, *ipso facto,* still liable for the full amount of damage to the plaintiff, regardless of the percentage of fault assigned.[27]

Auditors believe that the system of joint-and-several liability if not checked is capable of crippling the auditing profession. Moreover, they argue that if harm can be apportioned amongst multiple tortfeasors, it is only equitable that a single tortfeasor should be liable to the extent of his/her fault. Auditors sustain that the likely scenario is that they are the ones left to shoulder the entire burden, as the equitable distribution of judgment award is often sacrificed because of the complex and challenging task of aligning the degree of each of the tortfeasor's liability to the proportion of his/her fault.[28] In addition, auditors claim they are targets of unjustifiable litigation because they were held liable under a mere negligence standard. This contrasts with company directors and officers, often protected by the business judgment rule, which

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[21] (n 13) 873.
[22] ibid
[23] This is a defence mechanism employed in tort by defendants in common law jurisdictions to either completely bar the claim or minimise the damages to be paid by showing that the defendant has also been negligent. See *Godwin v Atlantic Coast Line R.R.,* 220 F2d 242 (4th Cir 1955), where the court held that the plaintiff had no action against the defendants for his contributory negligence.
[24] 19 Mass. 621 (1824)
[25] WBL Little, 'Contributory Negligence as a Bar to a Claim for Breach of the Implied Warranty of Merchantability' (2008) 30 *Campbell Law Review* 90.
[26] ibid
[27] (note 13) 874.
[28] T R Manisero and C Salem, *The Common Law Doctrine of Joint and Several Liability and the Realistic Implications of the 'Deep Pocket' Rule* (Wilson Elser 2014) 1 http://www.wilsonelser.com/files/repository/NatlJointSevLiability_Manisero.pdf accessed 10 May 2025.

incorporates a gross negligence standard.[29] Thus, given the different standards applied to accountants and directors, there may be circumstances in which auditors are found liable while the company's directors are exculpated.[30] This argument re-echoes the concern expressed by the Supreme Court of California in *Bily* as follows:

> An award of damages for pure economic loss suffered by third parties raises the specter of vast numbers of suits and limitless financial 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.[31]

Auditors also become liable because they are the only solvent parties when a business goes bankrupt.[32] Larger audit firms have become litigation targets because of the substantial capital they have built up. These firms' assets and insurance coverage have made them vulnerable to what is now referred to as the "deep pocket" theory. Auditors believe the "deep pocket" syndrome is the forebear of the much-dreaded doctrine of joint-and-several liability.[33] Under this doctrine, even though auditors may be less culpable for the plaintiff's loss, they are liable for the entire amount of damage if found negligent. This, in turn, encourages plaintiffs to go after the auditors directly because of their deep pockets.[34]

Another reason auditors are being targeted is perhaps that the public is looking for someone to hold responsible for their loss. According to Smith, moments of crisis are usually followed by low public perception of professionals, like auditors, who were, in principle, deemed partly responsible for it.[35] As is typical with a crisis, public outrage somehow fuels an increase in lawsuits against auditors, which sometimes helps to satisfy the public's desire for retribution. In addition, auditors have been sued for performing at a substandard level, fraudulently colluding with the company, or making it easier for the company's management to deceive investors and regulators.[36] However, the Private Securities Litigation Reform Act (PSLRA) 1995 introduced proportionate liability in the US to ameliorate joint and several liability except for fraud cases. On the other hand, the courts in Nigeria are circumspect in applying joint liability to auditors. They mainly require the proof to be directly linked to the auditor's work or grossly

[29] B Smith, 'The Professional Liability Crisis and the Need for Professional Limited Liability Companies: Washington's Model Approach' (1995) 18 Seattle University Law Review 568.
[30] ibid
[31] 834 P.2d 763 (1992).
[32] B Smith, 'The Professional Liability Crisis and the Need for Professional Limited Liability Companies: Washington's Model Approach' (1995) 18 Seattle University Law Review 557, 568.
[33] ibid
[34] ibid
[35] ibid
[36] ibid 569.

negligent. The Supreme Court reiterated this position in *Okeowo v Migliore*, stating that professional advisers, including auditors, owe a duty of care that could lead to liability if breached.[37]

2.2 Auditors Cashing in on Proportionate Liability

The grouse of auditors with liability litigations is based on a simple and common legal notion that damages are apportioned in accordance with a party's fault. As trite and logical as this precept may sound, it is untenable under tort liability claims against auditors because of the doctrine of joint-and-several liability.[38] Consequently, a plaintiff in a claim for damages may proceed against any tortfeasor of his or her choice to recover the entire amount of his or her loss, with no regard whatsoever to the defendant's contribution to the loss. Thus, if an auditor who audits a company fails to detect a fraud by the company's director, the claimant can sue either the auditor or the director to recover their full loss, irrespective of who is more culpable of the two. In practice, the auditor is always sued because of the capacity he or she has to shoulder the bill.[39] For this reason, auditors are often forced to settle an unwarranted claim to avoid the arduous task of litigation, potentially resulting in unlimited liability exposure.[40]

In addition, juries in the United States, like the general public, have difficulty overcoming the assumption that auditors investigate and validate all the transactions undertaken by their clients. This difficulty faced by "deep pocket" defendants in convincing a jury that an auditor's function is not necessarily equivalent to detecting all the errors in clients' financial statements often propels auditors to opt for settling an unwarranted claim.[41]

Overwhelmed by disproportionate liability regimes, auditors have sought a statutory reform to replace joint-and-several liability with a more constrained arrangement, such as capped or proportionate liability.[42] This method involves setting a cap on the damages a potential claimant can claim against the auditor or requiring that damages awarded be measured proportionally to the auditor's fault. With this proposition, the audit profession embarked on an active campaign, engaging political actors and regulators in their cause of reform at the national and international levels. However, the success of those efforts has been mixed so far.[43]

[37] [1979] 11 SC 138
[38] (n 28) 867.
[39] The auditor may seek a contribution from other co-defendants for an equitable amount, but the co-defendants are often unable to meet this liability. In the end, liability is imposed upon the defendant who has the means and is better placed to pay rather than the most negligent.
[40] (n 32) 569.
[41] ibid
[42] (n 8) 113.
[43] ibid 114.

Whereas some countries, especially in the aftermath of the Enron scandal, have re-examined their rules governing auditors' liability, others have adamantly refused to limit auditors' liability.[44] In the United States, for example, auditors cannot contractually limit their liability for negligence, as evidenced in the philosophy behind the passage of the Sarbanes-Oxley Act; this situation is not likely to change anytime soon.[45] Similarly, under Spanish law, auditors' liability is tortious, and third parties' rights cannot be limited by contract.[46]

Auditor liability litigation in the United States has long been a concern since the early 1970s. The influx of liability litigation during this period is partly attributed to the provision of section 10(b) of the Securities Exchange Act of 1934, which prohibits fraud in transactions involving the sale or purchase of securities.[47] This section invariably creates liability far beyond fraud to include any misstatement or omission of a material fact or any relevant information that would be important to investors in deciding to buy or sell stock. Because of its broad application, the Exchange Act antifraud provision has been used against all kinds of behaviour, from misleading statements in company filings to documents used to sell securities.

Moreover, under Title 18 of the US Code, investors may sue for fraudulent statements in a company's periodic filings with the SEC. Although difficult to prove, Title 18 gives investors a private right of action. It is advantageous because it creates potential liability for many defendants, including those who made the fraudulent statement, "control persons," and their aiders and abettors. This fact and liability insurance coverage enjoyed by auditors made them convenient litigation targets.

The legal theory of aiding and abetting soon became the basis of a flurry of liability actions even by individuals remotely associated with selling and purchasing securities. While securities actions can be said to represent only a fraction of liability claims brought against auditors, these suits generally popularised claims against auditors and opened the floodgates of litigations against auditors. Auditors, particularly, have become litigation targets because of the nature of their work. They are called to evaluate and exercise considerable judgment on materials and documents prepared by others in an environment not fully controlled by them. The complex scenario of an auditor's work was well explicated by the Supreme Court of California in the case of *Bily* as follows:

> 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

[44] As a result of the auditing profession's successful lobbying campaign, countries like Australia, Belgium, and Germany have adopted some statutory measures to limit auditors' liability.

[45] Lee Roach, 'Auditor Liability: Liability Limitation Agreements (Part 2)' (2010) 31 The Company Lawyer 177.

[46] Third parties' rights are guaranteed under article 1902, and the same cannot contract away. Any applicable cap to liability in Spain must be by the adapted provisions of the 8th Directive to be discussed further.

[47] (n 8) 119.

> furnishes the information base for the audit…Thus, regardless of the efforts of the auditor, the client retains effective primary control of the financial reporting process.[48]

The auditor must follow the requirements of Generally Accepted Accounting Standards (GAAS) in examining the audit materials and documents. Likewise, in reaching an opinion on the audit, he or she must be guided by Generally Accepted Accounting Principles (GAAP). These guidelines are set rules written in general terms, and their application is fundamentally based on the individual auditor's experience and professional judgment. Investors and the general public may seek a flawless or perfect audit, but by its nature, it is an exercise of estimation and judgment. Therefore, it is hardly ideal.

Thus, in the *locus clasicus* of *Bily v Arthur Young & Co.*, the California Supreme Court reasoned 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 complex factors. The court went on to conclude 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."[49] In other words, audit is "as much an art of judgment and experience as an axiomatic set of procedures."[50] Nigeria has slowly adopted formal proportionate liability standards, though judicial trends suggest a movement in that direction. Nigerian courts are inching toward a framework that mirrors the US approach by emphasising contributory negligence and fault allocation.

3.0 Early Legislation to Stem Liability Claims

Auditors have long complained about the disproportionate threat they face. Although for some analysts, the threat of litigation is another means of enhancing auditors' professional responsibility, thereby increasing the reliability of financial information. Nevertheless, "the threat of class action securities fraud litigation creates great financial risk for the profession," and auditors cannot find insurance.[51] Thus, even before the advent of the SOX, the accounting industry sought relief from the US Congress from litigation targeting deep-pocket defendants. As indicated earlier, "auditors are a favoured target of trial lawyers because any faulty judgment on the part of auditors may result in large monetary settlements. Accountants were also concerned about abusive discovery practices that imposed such burdensome costs that expensive settlements often were necessary."[52] Thus, in 1991, the audit firms successfully lobbied various states to

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[48] *Bily v Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992) at 762.
[49] ibid 763.
[50] (n 28) 883.
[51] T C Pearson and G Mark, 'Investigations, Inspections, and Audits in the Post-SOX Environment' (2007) 86 Neb. L. Rev. 43, 50.
[52] ibid

pass enabling legislation to establish a Limited Liability Partnership (LLP). Traditionally, audit firms practised as unlimited liability partnerships in which all the firm's assets and partners' assets were at risk once the firm was found liable by a court of law.[53] On the other hand, the liabilities of audit partners in a limited liability audit firm are limited to their contribution to the firm's capital. Almost all audit firms in the US are now LLPs.[54]

The second stage of this development was the audit firms' effort to reform joint-and-several liability, which was also rewarded by the US Congress overriding a presidential veto and passing the *Private Securities Litigation Reform Act* (PSLRA) in 1995.[55] The PSLRA was primarily an effort to prevent meritless "strike suits." It partially succeeded because it altered the nature of securities litigation against companies and auditors. Large institutional shareholders became more involved in securities class actions because the PSLRA ceded control of such actions to the most significant investor. The PSLRA minimised the exposure of external auditors by establishing a proportional liability system that reduced the potentially devastating consequences of joint-and-several liability.[56]

The PSLRA deterred both nuisance litigation and some unmeritorious cases. Further, the Act served as a precursor to SOX by expanding the legal reporting responsibilities of auditors. For the first time, statutory law required some specific "audit procedures," including procedures reasonably designed to detect material illegal acts related to the financial statements of public companies.[57] This was followed in 1998 by the *Securities Litigation Uniform Standard Act* (SLUSA). These laws, the LLP laws at the state level and the PSLRA and SLUSA at the national level, restricted claims to a proportionate liability model, except in cases where auditors commit a criminal offence, joint-and-several liability remains.[58] In Nigeria, the CAMA 2020 offered a general framework for auditor responsibilities but imposed few punitive measures for failures. Recent amendments have introduced stricter reporting obligations, yet enforcement remains inconsistent.

4.0 Global Dimension of the Liability Crisis

Over the years, the debate for reducing auditors' liability exposure has taken a global centre stage, and this was only reinforced by the large corporate scandals at the beginning of the twenty-first century in Europe, such as Ahold in Holland, Nordisk Fjer in Denmark, and Parmalat in Italy and the U.S., most famously,

[53] This liability was joint and several, exposing audit partners to respond to the liability obligations of their bankrupt co-defendants in fraud cases.
[54] Trevor Bush, Stella Fearnley and Shyam Sunder, 'Auditor Liability Reforms in the UK and the US: A Comparative Review' (2007) 8 http://depot.som.yale.edu/icf/papers/fileuploads/2575/original/07-33.pdf accessed 11 May 2025.
[55] (n 50) 51.
[56] ibid
[57] ibid 52.
[58] (n 53) 10.

Enron.[59] This conspiracy of problems has caused great anxiety over the scope of auditor liability, which led to a declaration in some quarters, at various times, to 'an epidemic of litigation'[60], an 'outrageous level of current claims'[61] and even a possibility that 'many audit firms face the risk of Armageddon'.[62]

This fear, coupled with the common belief within the accounting profession that liability claims against them are disproportionate to their fair share of the blame, led to the introduction of liability limitation clauses in audit contracts by auditors to protect themselves. As indicated above, in the US, the profession had successfully lobbied and secured the passage of LLP. The British government also approved the Limited Liability Partnership Act 2000 LLP option. In Spain, liability limitation through contract is not a novelty. Under Article 23, RAC auditors can negotiate and include liability limitation clauses in their contracts. According to Crespo, these clauses are justified because of increased liability claims against auditors, which eventually raise their professional insurance premiums.[63] However, the liability clauses must not affect the rights of third parties under Article 1902 CC.[64]

The industry's concern for the 'liability epidemic' was echoed through several pronouncements by influential professional bodies. In 1995, the International Federation of Accountants.[65] For instance, it issued a report that presented the results of a comprehensive survey involving member organisations in 36 nations. The report summarised the members' views on the legal liability regimes adopted in their countries. It used these to make a case for international regulatory action to establish clear and consistent limits on auditor liability.[66] It was argued that in those countries with unlimited liability regimes, such as the US or Australia, the public conceptions of the roles of an auditor were distorted and often unrealistic, fuelling excessive litigation activity against auditors. In contrast, limited liability environments maintained in other countries were seen to facilitate greater efficiency in auditors' work, while serving the public interest through rigid enforcement and compliance practices.[67]

5.0 Developments in the European Union (EU)

Although individual EU countries' positions vis-à-vis auditor liability have been diverse, the Eighth Company Law Directive on Statutory Audit did not deem it necessary to intervene. The Directive, designed to promote the Single Market principle by providing a uniform framework for the delivery of audit services,

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[59] S M Spell, 'Capping Auditor Liability: Unsuitable Fiscal Policy in Our Current Financial Crisis' (2010) 4 *Brooklyn Journal of Corporate, Financial & Commercial Law* 323, 332.

[60] Arthur Andersen & Co and others, *The Future of Financial Reporting* (1992) 19.
[61] Institute of Chartered Accountants of Alberta, *Opportunity, Equity and Fairness* (ICAA 1995) 11.
[62] Giles Ward, 'Auditors' Liability in the UK: The Case for Reform' (1999) 10 *Critical Perspectives on Accounting* 388.
[63] María Otero Crespo, *La Responsabilidad Civil del Auditor de Cuentas* (Aranzadi Thomson 2013) 213.
[64] ibid 371.
[65] International Federation of Accountants, *Articles of Merit – 1995 Competition* (IFAC 1995).
[66] (n 2) 10.
[67] ibid

made no specific reference to auditors' responsibilities, nor did it define the circumstances under which auditors could be held liable. Member states were left to determine, to a reasonable degree, liability for auditors who acted honestly and independently.

Concerns about the EU Member States' divergent liability regimes came to the fore in the 1990s when the EC-commissioned study entitled "The role, position and liability of the statutory auditor within the European Union"[68] concluded that the diversity was likely to hurt the development of auditing. Following the study's publication, the EC issued a Green Paper in the same year to foster further debate and consultation.[69] The Paper stressed that the liability problem had become a principal issue facing auditing. It highlighted differences in the statutory auditors' liability regimes across the EU as an impediment to the viability of the EU market. It concluded that these conditions might lead to a greater audit market concentration. Although the paper acknowledged that 'the liability of the auditor should be limited to amounts which reflect his degree of negligence',[70] it ultimately suggested that the capacity for such action should rest with member states in the following words:

> Action at EU level in this field is likely to be difficult. The audit profession is not the only profession which is struggling with problems of liability. Furthermore, the legal traditions in member states in the area of civil liability are quite different. It is for consideration whether the negative effects of a continuation of differences in the regulation of audit liability are significant enough to justify EU action, considering the difficulties which such action is likely to face and the possible discrimination which action specific to the audit profession might entail as regards other professions.[71]

Thereafter, in December 1996, a conference involving the stakeholders coordinated at the EU level was held. The conference brought together the European audit regulatory community, academics, preparers, and auditors.[72] The opening note to the section of the conference on the issue of auditor liability stated the following:

> We have saved probably the most difficult issue to the end of this Conference. Litigation against auditors is increasing. It is difficult to get an accurate picture of the extent of the problem because most cases are settled out of court. The situation is not the same in all member states. Rules on professional liability are not harmonized at EU level. The professional liability of auditors is dealt with differently at national level. There are systems of proportional liability, joint-and-several liability and indeed of limited liability. Is there a reason to limit the professional liability of the statutory auditor by law? Should this not be left to the parties concerned? To whom should the

[68] W Buijink, S Maijoor, R Meuwissen and A van Witteloostuijn, *The Role, Position and Liability of the Statutory Auditor within the European Union* (Maastricht Accounting, Auditing & Information Management Research Center 1996) http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/03/151&format=HTML&aged=0&language=EN&guiLanguage=en accessed 18 May 2025.
[69] ibid 9.
[70] (n 69) para 5.6.
[71] ibid para 5.7.
[72] ibid

> statutory auditor be held liable? Is there a reason for action at EU level? Is there a reason why the EU should take the initiative, as opposed to member states? Is it realistic to believe that one can deal with professional liability of auditors at EU level without at the same time tackling the liability regime of other professions? There is no doubt that we cannot give a final answer to this (sic) various questions today.[73]

The conference reached a consensus in its conclusions that the EU legislative framework on auditing needed improvement, which should derive from the IFAC's *International Standards on Auditing* (ISAs). However, opinions varied on the possible EU action on auditors' liability. The audit industry and FEE voiced their support for liability limitation. On the other hand, others expressed concerns that such a limitation would cause inferior audit quality and shift liability to other parties. The relative scarcity of actual court cases against auditors was also cited to indicate that existing liability regimes were not as harsh as claimed.[74] Karel van Hulle, the then Head of the EC's Financial Information Unit, in his overview of the comments received on the Green Paper, noted that:

> The commentators from the accounting profession regret the absence of a clear message in the Green Paper that a limitation of liability should be organized at EU level. Most other respondents think that there is no justification for reducing the professional liability of auditors as opposed to other professionals. These commentators believe in particular that a liability cap is not in a public interest.[75]

All this while, the EU's policy was based on a relatively 'non-invasive' strategy of coordination and collaborative encouragement of uniformity among member states to a more direct 'hands-on' approach to harmonization through legislative activity at the EU level. However, regarding audit liability, the Commission continued to insist that liability limitation was unnecessary and considered auditor liability as a primary "driver for audit quality".[76] However, a combination of factors that followed the demise of Enron in 2001, and the subsequent fall of Arthur Andersen, together with a strong reaction from auditors themselves, provoked a rethink on the part of the EU. The profession's forceful rhetoric following the collapse of Arthur Andersen, one of the Big Five audit firms then, resurrected earlier claims of 'cataclysmic' litigation and portrayals of auditors as ultimate victims of an unfair litigation battle that could potentially lead to another 'Big' firm failure with disastrous consequences for the longevity of the profession as a whole.[77] These claims were further reinforced by evidence of increased litigation in the post-Enron era, which helped to energise discussions around the importance of preventive regulatory policies.[78]

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[73] ibid 193.
[74] (n 65) 11.
[75] (n 69) 30.
[76] ibid 10.
[77] ibid 13.
[78] ibid

Following intense lobbying by advocates of liability reform, especially the *European Contact Group* (ECG), i.e. a lobbying body set up in 1993 by the Big Four and medium-sized auditors BDO and Grant Thornton to generate a united front for the larger firms in Europe.[79] Charles McGreevy, who succeeded Frits Bolkestein as European Commissioner for Internal Market and Services in November 2004, took the bait with Dutch MEP Bert Doorn. The two politicians contributed significantly to addressing the matter in the European Parliament.

The outcome of these developments caused the launch, in November 2005, of the European Forum on Auditors' Liability. The forum consisted of representatives of auditors, businesses, insurers, bankers, investors, and other interest groups. It assessed potential solutions that would moderate auditors' litigation risk. Later on in 2006, the Commission duly appointed the consultancy firm London Economics to undertake this study. It has been widely argued that this research project's outcomes became a major catalyst for the subsequent change in European policy on audit liability.

The London Economics report came out in October 2006 with findings that the market for international audits was highly concentrated and effectively controlled by the 'Big Four' networks, which significantly reduced the likelihood of any middle-tier auditor becoming an alternative to the Big Four firms. It also found that auditors' inability to find insurance covering their total risk has aggravated audit market concentration, thereby putting partners' assets at risk. It was, therefore, suggested that unlimited auditor liability combined with only limited availability of liability insurance left auditors unprotected against the 'catastrophic' consequences of growing litigation, increasing the likelihood of another large auditor's failure, and even endangering the effective functioning of a broader economy.[80] The report in this regard stated:

> A failure of one of the Big-4 networks may result in a significant reduction in large company statutory audit capacity if partners and other senior staff at the failed firm, the remaining Big-3 firms, and possibly even some middle-tier firms, were to decide that auditing is a too risky activity and therefore shift to other business lines. This would obviously create very serious problems for companies whose financial statements need to be audited. In such circumstances, a major increase in the price of statutory audits would be required to restore the equilibrium between demand for and supply of statutory audit services.[81]

The publication of the London Economics' report was soon followed by a public consultation on auditor liability launched by the European Commission (EC) in January 2007. The specific ideas that the forum has considered include:

1. A single monetary cap at the EU level;
2. A cap based on the company's size as a function of its market capitalisation;

[79] ibid

[80] ibid 15.

[81] London Economics, *Study on the Economic Impact of Auditors' Liability Regimes* (European Commission 2006) 134.

3. A cap based on a multiple of the audit fees charged by the company; or
4. Limiting the contribution of the audit firm to the damages suffered by the plaintiff (proportionate liability), either by statute or contract.[82]

McGreevy, an EU Internal Market Commissioner, praised the timeliness of these ideas: "There is a real danger of one of the Big Four being faced with a claim that could threaten its existence," he said.[83] The European Commission established an "*Auditors' Liability Forum*" to consider the issues, comprised of representatives from the Big Four firms and other constituencies. In January 2007, the European Commission issued a Staff Working Paper on "*Auditors' Liability and Its Impact on the European Capital Markets*," in which it noted an array of potentially adverse consequences if another Big Four audit firm were to fail, and also the challenges to attracting new audit firms to step forward. The Commission's Working Paper was based mainly on the study by *London Economics*.[84] In a January 2008 talk, McGreevy said, "I do not intend to impose the means by which liability is limited."[85]

In a turn of events on June 5, 2008, the European Commission proposed limiting liability awards against accounting firms where civil claims arise from audit work for listed companies. The recommendation principally "aims to protect European capital markets by ensuring that audit firms remain available to carry out audits on companies listed in the EU."

The EC explained its rationale as follows:

> Liability reform is an international issue where member states should take action. It is in the public interest to ensure sustainable audit capacities and a competitive market for audit firms at international level. In the light of the current audit market structure, liability risks arising from the increasing litigation trend combined with insufficient insurance cover may deter auditors from providing audit services for listed companies. If these structural obstacles (liability risks/lack of insurance) persist, mid-tier audit firms are unlikely to become a major alternative to the "Big 4" audit networks on European capital markets. But there is also a risk of losing some of the existing players. One of the reasons might be that catastrophic claims cause the collapse of one of the major audit networks.[86]

Among other details of the proposal, the limited liability scheme would not apply if there was intentional misconduct by an auditor. The EU believes that this proposal would encourage new entrants into the field, especially for smaller audit firms, and provide an optimal solution for improving the operation of the audit market due to increased fairness and predictability of auditors' risk exposure. Almost immediately, the European Commission's proposal was criticised by certain quarters, including the European lobbying group

[82] Directorate General for Internal Market and Services, *Commission Staff Working Paper: Consultation on Auditors' Liability and Its Impact on the European Capital Markets* (European Commission, Brussels 2007).
[83] ibid
[84] ibid
[85] *EU Commission to Offer Recommendations on Countries' Liability Caps for Audit Firms* (BNA Corporate Accountability Report, 4 January 2008).
[86] ibid

representing the insurance and reinsurance industries. And in August 2008, the *International Corporate Governance Network* (ICGN) attacked the European Commission's efforts to allow EU member states to impose auditor liability limits, arguing that the proposal would favour auditors "to the detriment of other stakeholders and especially shareholders."[87]

Positive praise from other organisations, such as the Federation of European Accountants (FEA), countered these negative commentaries. All said and done, the recommendations represent a great feat by the audit firms with their campaign in the European regulatory arena rather than at the individual member state level. Member states have eventually adapted their legislation to reflect this position, with Spain opting for proportionate liability of auditors. However, that is not the end of the argument because the proportion of the liability will still have to be determined by courts. In Nigeria, multinationals' cross-border operations demand a re-evaluation of liability norms to align with international best practices. With its extensive litigation culture, the US offers a cautionary example of the benefits and drawbacks of high auditor exposure.

Conclusion

Given the presumed role the threat of liability plays in reminding auditors that someone will hold them accountable in case of negligence or shoddy work. The argument by auditors of a potentially devastating liability is a bit exaggerated. Even the example of the demise of Arthur Andersen that is usually cited is an antithesis because Andersen did not fall because of judgment debt; it fell because of client flight as a result of its failure to do its job as an audit firm, and thereby lost its reputation. However, a good audit will essentially remove this threat. Therefore, capping auditors' liability only removes their incentive to do a thorough and accurate audit. Moreover, a threat of potentially catastrophic liability is not devastating because it will eventually have to pass the test of proof in the courts, which is enormous. In a financial crisis provoked in part by corporate scandals, you do not remove investors' most crucial solace, but whether this solace is real is subject to proof.

[87] J C Dickey, 'Auditor Liability "Caps"–The Politics of Catastrophe' (2008) 5 *Securities Litigation Report* 8.