WRITTEN TESTIMONY OF

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U.S. DEPARTMENT OF THE TREASURY

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Chairman Levitt, Chairman Nicolaisen, members of the Committee, Treasury staff and Observers:

I am Kathryn Oberly, Americas Vice Chair and General Counsel of Ernst & Young. I appreciate the opportunity to offer my views on some of the important issues that the Committee is addressing.

I have worked as an in-house lawyer for EY for more than 17 years, including nearly 14 years as the firm's General Counsel. I previously worked at the Department of Justice in various capacities, including as an Assistant to the Solicitor General, and was also a partner in a major national law firm. During my time at EY I have supervised the handling of hundreds of lawsuits against the firm. Unfortunately, as I believe you know, it is a fact of life that accounting firms are frequent litigation targets.

This fact hasn't really changed during the past 17 years. There have been ups and downs in the number of lawsuits, but not enough to remove accounting firms from the category of "chronic defendants." Meanwhile, the size of the damages being claimed has grown

substantially, in tandem with the growth in market capitalization of the firms' audit clients.

This caseload exists, and continues to expand, notwithstanding our firm's, and I believe other major firms', strong commitment to audit quality. We spend well in excess of $100 million dollars every year in training our personnel, in providing national office support to audit teams, in developing new auditing tools, and in other activities directed toward improvements in audit quality. Particularly in recent years, since the collapse of Arthur Andersen and the passage of the Sarbanes-Oxley Act, the profession has become much more focused on audit quality and on its obligations to the investing public, a fact that is, I believe, generally recognized.

Significantly, firms like Ernst & Young are now regulated entities. We are subject to annual PCAOB inspections. And, if you ask one of our line audit partners, he or she will most likely tell you that the PCAOB inspection process is far more of a concern than is the threat of private litigation. The inspections are a certainty; every year the PCAOB will select a random sample of audits for a thorough and rigorous review. Litigation is much more uncertain and random.

And it is precisely because of that randomness and uncertainty that litigation is such a threat to the survival of the major accounting firms. Our risk exposure generally stems from an externality, that is, the client's market capitalization. This can range from millions of dollars to tens of billions of dollars.

I think it is helpful to remind ourselves of an important element of this risk: it would have been inconceivable to the authors of the federal securities laws. At the common law, accountants' liability was quite restricted. At least for actions alleging negligence, accountants could be liable only to persons with whom they were in privity – and that is essentially still the law in cases brought against the firms in most state courts. As Chief Judge Cardozo discussed in the famous 1931 decision, *Ultramares Corp. v. Touche,* courts were concerned about exposing accountants "to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."[1] In the federal courts, however, the privity requirement for actions under Rule 10b-5 under the Securities Exchange Act began to be watered down and eventually abandoned several decades ago. At least since *SEC v. Texas Gulf Sulphur Corp*.,[2] a 1968 Second Circuit decision, a person can be liable to the entire investing public whenever that person or an entity makes a material misstatement or actionable omission that is likely to affect the investing public. This is true regardless of whether the person making the statement has any self-interest in the matter.

The abandonment of the privity requirement in the federal courts happened with little fanfare (presumably because Rule 10b-5 is supposed to be directed at cases of actual fraud – I address that point later). Much more attention was given to the second major doctrinal development that threatened accountants' livelihood – that is, the abandonment of an actual reliance requirement. Under the Supreme Court's 1988 decision in *Basic v.*

[1] 255 N.Y. 170, 179-80, 174 N.E. 441, 444 (1931).
[2] 401 F.2d 833 (2d Cir. 1968).

Levinson,[3] accountants became liable not only to people with whom there was no privity but also to people who didn't even rely on what the accountant said or did if such a person purchased or sold a security in a so-called efficient market.

The end result of these developments in the law is that accountants' liability became potentially enormous. Without consideration by Congress or regulators of the broad policy implications, accountants essentially became equivalent to insurers or guarantors of the nation's securities markets.

Because of statutory and regulatory restrictions, accounting firms could not control audit risk through contractual arrangements, unlike other professions or businesses. Unlike underwriters, we couldn't limit our liability through indemnification agreements or other limits on liability – the SEC's independence rules wouldn't allow us to do so. Unlike attorneys, we couldn't avoid liability on the ground that no statement is made to investors – we do make statements; namely, we sign audit opinions. Unlike credit rating agencies, we couldn't escape liability by asserting protection under the First Amendment. As a result, we became highly attractive deep pocket defendants.

And, although I have, of course, simplified matters, that is how things stand today. There have been helpful developments in the law, such as the passage of the Private Securities Litigation Reform Act in 1995 and the Supreme Court's *Central Bank* decision in 1994.[4]

[3] 485 U.S. 224 (1988).
[4] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

At the same time, however, the market capitalizations of the firms' audit clients have increased several-fold, greatly expanding our liability exposure.[5]

I want to be clear about what keeps me up at night. It is not the run-of-the-mill lawsuit which, rather shockingly, in my world means a lawsuit with potential exposure for anything less than, say, 50 or 100 million dollars. We understand that auditing carries a risk of lawsuits, and, like other sectors of the economy, we understand that we will inevitably have liability exposure. The real issue is uninsurable catastrophic risk. It is the mega-case – for our firm, a lawsuit for $500 million, or a billion dollars, or two billion dollars or more -- that prompts me to toss and turn. These cases are very difficult to settle, and yet we generally have no choice if we can't get them dismissed on motion. It would be quite foolhardy for us to go before a jury on a "bet-the-firm" case. I worry too much about the well-being of my 2400 Ernst & Young U.S. partners, and of their spouses and their children, and the well-being of our 30,000 employees, to rely entirely on the hope that a jury of laypersons will understand the complexities of claims asserted against us and the validity of defenses when the survival of the firm is at stake.

Audit firms and professionals know that outstanding, top-quality audits are expected by the markets for the benefit of investors. And we believe the markets are entitled to those top-quality audits. Quality comes first, both for us and for investors. But there's something fundamentally wrong with a litigation system that effectively denies audit firms access to the judicial system even when they've done the quality work expected of

[5] *See* Chart 13, Average Public Company Common Stock Capitalization, p. 45 of the Report of the Major Public Company Audit Firms to the Department of the Treasury Advisory Committee on the Auditing Profession (January 23, 2008)

them. When challenged in court, we ought to be able to defend our work on its merits. But when we're faced with catastrophic, bet-the-firm claims, we do not get the chance to do that.

The risk is that, either by design or by miscalculation, a plaintiff may demand a settlement payment a firm cannot afford, leaving no option other than trial. A jury could easily return a verdict much larger than what the audit firm could afford to pay. No firm has insurance coverage for the largest of claims, no firm has the capital to pay the largest of claims, and no firm could retain its partners by slashing future earnings by an amount necessary to pay the largest of claims.

The data compiled by the firms and submitted to this Committee show the extent of the threat confronting the firms. The six largest firms currently confront 90 cases with claims in excess of $100 million each, totaling an astounding 140 billion dollars, including 27 lawsuits with potential damages in excess of one billion dollars each and seven lawsuits with potential damages in excess of 10 billion dollars each. Certainly, nothing close to the $140 billion aggregate amount will ever be paid by the firms to resolve these lawsuits. But it would take only one successful mega-claim lawsuit to bring down one of the major accounting firms.

The firms are private partnerships. The capital invested in the firms is provided by the partners themselves and is often funded by individual partners with bank loans. The bankruptcy of a firm would result in the loss of most if not all of the capital of its partners

– and would still leave each partner with the requirement to repay his or her individual capital loans.

I have heard it said on other occasions – including even in testimony before this Committee – that we really shouldn't worry about a lawsuit that would bring down the firm because plaintiffs' lawyers would never let it happen. The notion is that the plaintiffs' law firms would never allow the golden goose to die. But, aside from the obvious peculiarity of making a public policy decision based on the assumed good graces of the plaintiffs' bar, the assumption is incorrect. In my experience, the plaintiffs' bar includes many "one-off" or "outlier" players who would never even consider foregoing a litigation bonanza if one were within reach. This is particularly true in cases involving litigation and bankruptcy trustees – an area I will discuss in a moment.

So what can be done?

Assuming there is a consensus that the public interest is served by maintaining a private sector public company auditing function, there needs to be a recognition that the liability risk to the firms is simply too great. In my view, it cannot be justified as a policy matter. The U.S. regime of private litigation is generally defended based on a deterrence argument – the theory is that private lawsuits are a "necessary supplement" to SEC enforcement. But the current regime of PCAOB and SEC inspections and enforcement cases by itself provides deterrence to poor auditing, and even more deterrence exists when such regulatory actions are coupled with some level of private enforcement. The

question is whether any deterrence is added by keeping a nuclear bomb in the arsenal. I do not think it can plausibly be said that an auditor will do a good job auditing only when there is a threat of a multi-billion dollar lawsuit, and he or she won't do such a good job when the liability threat is quite real but at an amount that the accounting firm can actually withstand.

In addition to deterrence, the existing litigation regime is generally justified on a compensation basis. But there is substantial academic literature that shows why compensation doesn't work effectively.[6] Injured investors don't get much of their investment losses back, and there are huge transaction expenditures on lawyers, expert witnesses, and so on.[7]

The most meaningful long-term solution would be some type of cap on liability. I know that the idea of caps raises hackles in some quarters, but I am genuinely puzzled as to why policymakers tend to shy away from seriously considering it as an appropriate solution. This is not a new idea being cooked up by the accounting profession. For example, as long ago as the 1970s and early 1980s, years before the explosion in numbers and size of securities lawsuits, the American Law Institute's Federal Securities Code

[6] See Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639 (1996); John C. Coffee, Jr., *Litigation and Corporate Governance: an Essay on Steering Between Scylla and Charybdis*, 52 Geo. Wash. L. Rev. 789 (1984); John C. Coffee, Jr. *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534 (November 2006).

[7] See *Letter from Donald C. Langevoort et al. to the Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission* (Aug. 2, 2007) (letter signed by six prominent law professors stating "when the current system delivers this compensation to those who bought or sold during the class period, it does so at a relatively high cost in terms of plaintiffs' and defendants' attorneys fees and related expenses").

would have provided for caps. Drafting of the Code, some of you may recall, took more than a decade. It was led by the nation's leading securities scholar, Professor Louis Loss of Harvard University, with broad participation from others. The massive law reform proposal never got out of congressional committee – it was too ambitious a project (although the Code did have an impact on the development of many aspects of the securities laws). As for civil liability, the Code would have capped liability exposure to a maximum of $1 million unless the fraud was made with "knowledge," a standard that was intended to be higher than the *scienter* standard. Obviously the $1 million cap would be insufficient in the current economic environment. But my point is that caps designed to limit the "indeterminate" loss that worried Judge Cardozo were viewed as an appropriate solution long before any of the accounting firms began to talk about catastrophic risk and sustainability. In more recent years other prominent securities law scholars have also supported various types of liability caps.[8]

And the idea has considerable support outside the U.S. Just last week European Internal Market Commissioner Charlie McCreevy announced that the European Commission would, before summer, adopt a recommendation to put a cap on auditors' liability. It will encourage member states to adopt a cap, with the precise form of the cap being left to member states to decide. In Belgium and Germany, auditors' liability is already capped, while in the UK liability is subject to contractual arrangements between the auditing firm and the company being audited. Surely our global economy demands serious

[8] See, e.g., Langevoort, *Capping Damages*, supra note 6; John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 342 (2004); Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365(2004).

consideration of making the same protections available to audit firms in the United States.

Short of caps, there are incremental changes that could be made to improve the litigation situation. One improvement, which isn't something that I expect could happen overnight, is to require actual knowledge for liability under Rule 10b-5, instead of mere recklessness. All circuits permit a plaintiff to meet the *scienter*, or knowledge, requirement by showing that the defendant acted recklessly (although the Supreme Court has never decided this issue). Indeed, the adoption of a recklessness standard for Rule 10b-5 actions probably has had as much impact on our firms' liability exposure as has the abandonment of privity and the actual reliance requirement.

The absence of clear separation between the concepts of recklessness and a simple lack of adequate care creates a significant, and unique, problem for auditors of financial statements. Unlike most other defendants, auditors typically don't have any financial interest other than their audit fees and the audit work consists of selective testing of the amounts and disclosures in the financial statements. An auditor does not audit every transaction or every item within a financial statement category. All audits involve substantial professional judgment. But in Rule 10b-5 cases against auditors, the allegation typically is that the auditor defendant "should have done more" – that he or she failed to investigate sufficiently the circumstances alleged to have constituted "red flags" -- and that this failure constituted recklessness. Courts and juries have a difficult time figuring out when and whether the recklessness standard is met. It simply isn't true that

the *scienter* requirement under Rule 10b-5 protects good faith conduct from litigation risk. An actual knowledge standard would be a huge improvement.

Consideration also should be given to caps on appeal bonds. This is far different from the sometimes contentious discussion about caps on liability; this is about open access to the judicial system. In the federal system, a defendant that loses at trial generally may obtain a stay of the adverse judgment pending an appeal only if the defendant posts a *supersedeas* bond that equals the amount of the judgment plus projected interest and costs. For a large judgment, posting the bond in the required amount is at best extremely expensive and difficult, and it may be impossible. A losing defendant that cannot post a sufficient bond may be forced to declare bankruptcy or settle the case, foregoing an appeal. Significantly, the mere prospect of a very large, unbondable judgment may cause a defendant to accept a settlement before the case even goes to trial.

Federal district courts do have the discretion to lower the size of the bond, but this discretion is limited. Many state legislatures have recognized the need for a cap on the maximum size of an appeal bond in state court. At least 23 states have done so. Federal legislation on this issue would be helpful to prevent the collapse of a major firm simply because the firm could not afford to have an adverse jury verdict reviewed on appeal.

Another improvement would be the provision of exclusive federal jurisdiction for claims against accounting firms that are registered with the PCAOB, where such claims relate to the performance of professional services. Federal courts generally offer more

predictable procedures and outcomes than do state courts. The accounting firms are now subject to a pervasive scheme of federal regulation, and, accordingly, it seems quite sensible that lawsuits involving matters relating to professional services should be litigated in federal court. This change generally would not have any effect on shareholder claims, which are brought in federal court by statute, but would affect some lawsuits, such as those typically brought in state courts by litigation trustees (an area of litigation that I discuss further below).

The increased fragmentation of class action litigation is also something that deserves greater attention and an attempt at solution. Some plaintiffs' lawyers have begun to adopt a strategy of opting out of securities class actions and filing separate cases on behalf of a single plaintiff in state or federal court. They seek to move the case along rapidly, forcing the defendant either to settle the case at a high price or go to trial, in which case a loss would likely prevent the defendant from litigating the merits of the class action because the earlier verdict would have collateral estoppel effect on subsequent cases. Another strategy that seems to be gaining in popularity among the plaintiffs' bar is opting out late in the class action, at the settlement stage, and bringing a separate case at that time in an effort to obtain a larger payment from the settling defendants.

These strategies can increase litigation expenses and settlement costs substantially. Congress could address the issue by providing for a mandatory stay of claims in federal or state court that fall within the scope of a pending federal class action, or by providing

for mandatory coordination of proceedings in the individual and class claims. This would give priority to adjudication of the class action, which is, of course, the preferred method of resolving legal disputes involving large numbers of potential claimants.

Another area that I would like to discuss briefly is litigation brought by trustees and receivers of bankrupt audit clients. This is one of the principal sources of large litigation claims against the firms. Bankruptcy courts frequently transfer claims to "litigation trustees," whose sole purpose is to obtain as much money as possible from the accounting firm for the benefit of the creditors of the audit client that are the beneficiaries of the trust. These creditors do not have to put up any money to fund the litigation, and thus they have no incentive to weed out frivolous claims. Conversely, the attorneys for these trusts are often paid for their work on an hourly basis with an additional payment based on the amount of recovery – they therefore have an interest to exhaust every possible avenue for obtaining a large payout for the trust.

These claims often involve fraud or other unlawful activity by senior officers or employees of the defunct audit client. The trustee or the receiver asserts that by failing to detect the fraud the auditor is responsible for the failure of the audit client.

The claims being asserted are those that would have belonged to the company were it still in existence. In other words, the trustee "stands in the shoes" of the defunct company. But the common law doctrine of *in pari delicto* traditionally precludes a party from recovering damages when the harm resulted as much from the plaintiff's wrongful

conduct as from the defendant's alleged negligence, which should make this type of claim difficult to bring. However, some have urged a contrary conclusion. Thus, in *NCP Litigation Trust v. KPMG LLP*,[9] the court held that New Jersey law does not provide for imputation to the audit client of the knowledge and acts of its employees. This shouldn't be the law. There is no reason that a company's claim should improve merely because it is being asserted by a litigation or bankruptcy trustee rather than by the company itself. State or federal legislation could codify the imputation doctrine, particularly in jurisdictions that do not currently have well-settled imputation standards. This is an important area of the law that deserves more attention.

Most of these ideas are not particularly novel. They have been discussed for many years. And the litigation crisis facing the profession has been recognized by study group after study group, by expert after expert. The Committee's draft report does acknowledge the civil litigation risk and others as being real, and it states a belief that the loss of one of the larger auditing firms would likely have a significant negative effect on the capital markets. I would suggest that the final report should be more pointed in recognizing the severity of the unlimited nature of litigation and the impracticalities of taking a bet-the-firm case to trial, and also in urging policymakers to address these issues at the earliest possible opportunity. The draft report addresses the litigation threat in the context of audit market concentration and competition, and recommends that the threat be addressed through two initiatives – first, that the PCAOB should monitor potential sources of catastrophic risk that would threaten audit quality, and, second, that a mechanism be established to assist in the preservation and rehabilitation of a troubled auditing firm

[9] 901 A.2d 871 (N.J. 2006),

While there may be some merit in both of these proposals, they would not appear to provide the PCAOB (or anyone else) with sufficient tools to pro-actively address catastrophic risk.

There has been some talk about whether it would be appropriate to require firms to meet the same disclosure requirements that apply to our public company clients, including providing audited financial statements to the regulators or even the general public. We are not currently required to provide such information in securities class actions or in other types of lawsuits. We have disclosed such information in a very small number of cases where the plaintiffs were seeking punitive damages. Thus, imposition of a new 10-K-type public filing requirement on accounting firms would be a major change from current practice. We do not have public investors who might need this type of information, and I frankly don't see why such information would be particularly useful to anyone, except perhaps to our regulators. On the other hand, there is no doubt in my mind that providing the plaintiffs' bar with access to such financial data would worsen the litigation crisis that we are dealing with today. If this idea is to be pursued, it is important to take only careful, incremental steps – if additional disclosures are required from the firms, they should be limited to disclosures made to the PCAOB.

I do want to make clear that all of the reforms I have been discussing are, in my view, not only in the best interests of Ernst & Young and other accounting firms but also in the best interests of the investing public. I do not think that having unlimited accounting firm liability is sound public policy. As I noted before, a regime of uninsurable, catastrophic

risk doesn't serve either the deterrence or the compensation goals that underlie federal securities litigation. And it would not be in the best interests of the capital markets or investors if we were to lose another major accounting firm. The risks are substantial that that could happen, and it is an issue that needs to be tackled head-on.

I would welcome any comments or questions.