REGULATING LARGE INTERNATIONAL ACCOUNTING FIRMS: SHOULD THE SCOPE OF LIABILITY FOR OUTSIDE ACCOUNTANTS BE EXPANDED TO STRENGTHEN CORPORATE GOVERNANCE AND LESSEN THE RISK OF SECURITIES LAW VIOLATIONS?

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I. INTRODUCTION

With the collapse of Andersen Worldwide S.C. in 2003,[2] only four global accounting "networks" remain.[3] The "Big Four" currently include: (i)

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[2] *See* Jennifer M. Niece & Gregory M. Trompeter, *The Demise of Arthur Andersen's One-Firm Concept: A Case Study in Corporate Governance*, 109:2 BUS. AND SOC'Y REV. 183-88 (2004); *see also* Lawrence Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 CONN. L. REV. 915 (2003). Professor Cunningham provides an informed and balanced analysis of the possible implications the Sarbanes-Oxley Act can have on the auditing industry and corporate governance in general. *Id*. at 941-75. He notes that Andersen's demise was set in motion by four separate matters: Enron, Global Crossing, Qwest, and Worldcom. *Id*. at 926-36. In each case, it appears that the wrongdoing by the U.S. entity Arthur Andersen L.L.P. was at issue and not Andersen Worldwide S.C. *Id*. at 926.

Notably, the indictment filed against Arthur Andersen L.L.P. did not name Andersen Worldwide S.C., the Swiss entity that served as the umbrella organization for all accounting firms operating under the "Andersen" name throughout the world. The indictment filed against Arthur Andersen L.L.P. is available at http://news.findlaw.com/hdocs/docs/enron/usandersen030702ind.html (last visited Aug. 27, 2004).

Andersen Worldwide S.C. was a separate legal entity from its members, including Andersen Consulting. Jennifer M. Niece & Gregory M. Trompeter, *The Demise of Arthur Andersen's One-Firm Concept: A Case Study in Corporate Governance*, 109:2 BUS. AND SOC'Y REV. 183, 188, 195 (2004) (discussing the history of Arthur Andersen since its establishment in 1913). The title of the article is slightly misleading because the authors use the term "One-Firm Concept" to convey that the consulting, audit, and tax operations of the firm were conducted under the Andersen name for most of its history, before the operations were eventually split and delegated to Andersen Consulting ("AC") and Arthur Andersen ("AA"). *Id*. at 189, 195. Niece and Trompeter reiterate that Andersen opted for the business strategy of forming a Societè Cooperative in Geneva Switzerland, the members of which were separate legal entities organized under the laws of the state in which the individual members were formed. *Id*. at 187-88. *See also* MICHAEL B. BIXBY, THE ENRON/ARTHUR ANDERSEN

Deloitte Touche Tohmatsu (now doing business under the name "Deloitte"), (ii) Ernst & Young Global ("E&Y"), (iii) KPMG International ("KPMG"), and (iv) PriceWaterhouseCoopers, Ltd. ("PwC").

Within the United States, the Sarbanes-Oxley Act of 2002 ("Act") improved the regulation of accounting firms[4] authorized by the Securities and Exchange Commission ("Commission" or "SEC") to conduct public audits of corporations.[5] The Act explicitly grants to the Commission the right to "promulgate such rules and regulations, as may be necessary or appropriate in the public interest for the protection of investors, and in furtherance of the Act."[6] The Commission's authority extends to "persons associated with a public accounting firm (or a 'registered' accounting firm)."[7] Its regulatory reach covers "any individual proprietor, partner,

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DEBACLE: A CASE STUDY AND LEGAL IMPLICATIONS (Carol Zaino ed., Prentice Hall 2003) (2002) (focusing on the specifics of the relationship between Arthur Andersen and Enron); John Plender, *Problems at Ahold, Parmalat, and now Adecco raise new questions about how global accounting firms should work with multinationals and the risks of modern investment management techniques*, FIN. TIMES, Jan. 22, 2004, at 15; Barry R. Ostrager, Peter C. Thomas & Robert H. Smith, *Andersen v. Andersen: the Claimants Perspective*, 10 AM. REV. INT'L. ARB. 443 (1999).

3 The members of these entities generally perform external audits of U.S. public corporations in accordance with Generally Accepted Accounting Principles ("GAAP"). The Financial Activities Standards Board ("FASB") is the principal promoter of GAAP standards. While GAAP is a "rule-based" system of accounting, the results of two external audits performed according to GAAP by two different entities may vary considerably given the large amount of discretion exercised by such entities. Furthermore, GAAP vary in different countries. *See* Stephen A. Zeff, *International Accounting Standards: U.S. GAAP Confronts the IASB: Roles of the SEC and the European Commission*, 28 N.C. J. INT'L L. & COM. REG. 879, 884-85 (2003).

The International Accounting Standards Board ("IASB") is the leading body working in the area of audit standard harmonization and the leading force behind the development of the International Accounting Standards ("IAS"). *Id*. at 879, 886. In addition, there are other organizations involved in refining IAS, such as the International Federation of Accountants ("IFAC"). In contrast to GAAP, IAS is a "principle-based" system. Despite efforts to standardize accounting practices, auditors exercise considerable discretion and judgment in how the finances of a corporation are depicted. *See also* Frederick Gill, *International Accounting Standards in the Wake of Enron*, 28 N.C. J. INT'L L. & COM. REG. 967, 968-69 (2003); IFAC's website at http://www.ifac.org/About/ (last visited Aug. 27, 2004).

4 For the purposes of this article, the term "accounting firms" is used even though many offer a wide range of services, including performing both internal and external audits and providing tax advice and legal counsel.

5 Sarbanes-Oxley Act of 2002, 15 U.S.C.A. §§ 7201-7266 (Supp. 2004).

6 *Id*. § 7202. In addition, each state has regulatory authority in this area not reserved to the federal government, though jurisdictional issues sometimes arise. *See, e.g.*, Dale A. Oesterle, *Early Observations on the Prosecutions of the Business Scandals of 2002-03: On Sideshow Prosecutions, Spitzer's Clash With Donaldson Over Turf, the Choice of Civil or Criminal Actions, and the Tough Tactic of Coerced Cooperation*, 1 OHIO ST. J. CRIM. L. 443 (2004) (discussing the competition between New York and the Federal Government in the regulation of securities).

7 15 U.S.C.A. § 7201(9)(A).

shareholder, principal, accountant, or other professional employee of a public accounting firm, or any other independent contractor or entity" that performs work in connection with the "preparation or issuance of any audit report."[8] Significantly, foreign entities and individuals are within the SEC's scope of regulatory and enforcement authority.[9]

The Act aims to strengthen auditor independence by reducing the potential for conflicts of interest that may influence the public auditing process. This is accomplished, in part, by limiting the type of work that a public accounting firm may undertake on behalf of the corporation it is auditing.[10] The Act also grants to the Commission and other governmental bodies enhanced investigatory powers and the Act establishes greater sanctions for improper conduct.[11] Importantly, the Act recognizes the internationalization of the U.S. securities market by treating foreign public accounting firms that have contributed to the audits of U.S. corporations and issuers of securities trading in the United States in the same manner as domestic U.S. accounting firms with respect to the Commission and the newly created Public Company Account Oversight Board ("Board").[12]

In recent years, the practice of accounting, like that of law, has increasingly evolved from a profession into a business.[13] As a result, Professors Jonathan Macey and Hillary A. Sale persuasively argue that the market can no longer rely on financial information generated by auditors. The Professors note that:

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[8] *Id*.

[9] *See infra* notes 67-74 and accompanying text.

[10] *See id*. §§ 78j(1), 7201(11), 7213, 7216, 7231. The Act mandates new requirements governing the relationship between the audit committee within the corporation and the external auditor of the corporation. *Id*. These requirements represent the establishment of stricter rules, rather than the creation of new requirements where previously there were none. *See* Michael Cahn & Michael Scanlan, *Tools You Can Use: Helping the Audit Committee Manage Its Relationship with the Outside Auditor*, ACC DOCKET, May 2004, at 84-97.

[11] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 801-07, 901-06, 1101-07, 116 Stat. 745, 800-10 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, 29 U.S.C.A. (2004)).

[12] 15 U.S.C.A. §§ 7211, 7216. The Board's website is available at http://www.pcaobus.org/ (last visited Aug. 27, 2004). In Spring 2004, Board Member Daniel L. Goelzer gave a speech in which he discussed various topics including the globalization of auditing and practical problems, a subject he described as "vast and complex." http://www.pcaobus.org/transcripts/Goelzer_2004-04-19.asp (last visited Aug. 27, 2004) (transcript of speech). In his presentation, he discussed the difficulties the Board faced in regulating foreign issuers of securities and non-U.S. auditors, including striking the right balance between cooperation with foreign authorities and the United State's assertion of extraterritoriality. *Id*.

[13] Jonathan Macey & Hillary A. Sale, *Lessons from Enron, How did Corporate and Securities Law Fail? Observations on the Role of Commodification, Independence and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1167 (2003).

> the internal corporate governance structure of the big accounting firm is fundamentally flawed, and that this flaw contributed to the current crisis of confidence in the integrity of public reporting. The incentive structure within accounting firms makes it virtually impossible for auditors to be independent of significant clients like Enron. This flaw has led to a gradual, but fundamental, change in the basic balance of economic power between accounting firms and their audit clients. In combination with the lack of accountability created by the limited liability partnership ("L.L.P.") and the regulatory commodification of audits, this flaw has led to a market in which audits are bought and sold. As a consequence, audits no longer serve the economic purpose - providing information that protects investors and leads to efficient pricing of securities - which they once served.[14]

While the Act's enactment (and application) may have lessened these professors' concerns with respect to activities in the United States, it is not self-evident that the issues they have identified have entirely disappeared. As other countries adopt rules that accomplish functions similar to some of those mandated by the Act, the likelihood that similar corporate governance and auditing failures might occur should be reduced, but certainly not eliminated.

This article contends that while the Act strengthened the regulatory environment for combating certain financial crimes, it missed an important opportunity to prevent the use of complex corporate structures to facilitate such crimes. For the securities market to operate more effectively, it will probably be necessary for the SEC to (i) aggressively exercise its jurisdiction over foreign accountants, and (ii) continue to improve its cooperation with foreign securities regulators. These steps alone, however, are not sufficient to eliminate wrongful corporate activity and securities violations. Where the rewards for illegal conduct are high, some individuals will always be willing to take risks, particularly when the penalties for so-called "white collar" crimes are significantly less severe than the penalties for most violent crimes.

As mentioned above, limited improvements in corporate governance and securities regulation may be possible through improved international cooperation by law enforcement and regulatory authorities. The United States should continue (and expand) its work with foreign countries to develop common regulatory approaches towards cross-border transactions

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[14] *Id.*

and the operations of multinational corporations. Institutions such as the International Organization of Securities Commissions ("IOSCO"), the Organization for Economic Cooperation and Development ("OECD"), the World Bank, and other governmental, multinational, and non-governmental bodies have important roles in this area.[15]

This article is organized into four parts. The first part examines how large international accounting firms operate in theory and in practice.[16] The second part discusses U.S. enforcement of its securities legislation, noting some of the changes introduced by the Act, and examines how this legislation might impact the Big Four and their member firms.[17] The third part assesses the feasibility of making U.S. accountants and persons associated with public accounting firms more effective gatekeepers for the U.S. corporate and securities regulatory system, as envisioned by the Act.[18] The final part offers some brief observations.[19]

II. A BRIEF OVERVIEW OF HOW LARGE INTERNATIONAL ACCOUNTING FIRMS ARE STRUCTURED AND OPERATE: THEORY AND PRACTICE

The Big Four hold themselves out as membership organizations. Under this model, each member is composed of legally separate and independent accounting firms that are usually organized as limited liability entities. Ostensibly, these member firms render services for fees to their respective clients.[20] Generally, each member firm does not have an

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[15] The website for IOSCO is at http://www.iosco.org (last visited Aug. 27, 2004) and the website for OECD is at http://www.oecd.org/home (last visited Aug. 27, 2004). The website for the World Bank is at http://www.worldbank.org (last visited Aug. 27, 2004).

[16] *See infra* notes 20-37 and accompanying text.

[17] *See infra* notes 38-75 and accompanying text.

[18] *See infra* notes 76-89 and accompanying text.

[19] *See infra* Part IV.

[20] In 1999, approximately 5,500 non-tax lawyers were practicing law under the auspices of one of the Big Five accounting firms. John Paul Lucci, Note, *New York Revises Ethics Rules to Permit Limited MDP [Multi-Disciplinary Practice]: A Critical Analysis of the New York Approach after Enron, and Recommendations for Other Jurisdictions*, 8 FORDHAM J. CORP. & FIN. L. 151, 152 (2003). At the time, PwC was the third leading employer of attorneys in the world. *Id*. It is often difficult to differentiate the practice of law from the giving of tax advice. *Id*. at 153. Clients frequently find it attractive (and cost effective) to deal with a single service provider rather than retaining both accounting and law firms. *Id*. at 154.

Most jurisdictions in the United States follow the American Bar Association's rule against "fee splitting" by lawyers with non-lawyers. *Id*. at 155. This prohibition does not exist in many European countries (as well as the District of Columbia). *Id*. at 161-72. The special ethical rules governing the legal profession are often given as the rationale against permitting MDPs; the concern being that financial considerations may cloud a lawyer's professional judgment. *Id*. at 172-76. Potential conflicts of interest, however, often militate against the use of MDP service providers. *Id*. at 154.

ownership interest in, exercise control over, or have management responsibilities for another member firm (although an individual may hold posts within both a member firm and the umbrella organization).[21]

On first impression, the Big Four may appear similar to trade associations. Certainly, trade associations issue codes of conduct, organize both membership and public events, and provide information to members and the public. They may also engage in lobbying activities. Further, trade associations need not necessarily accept all applicants as members. Some are selective and others are not. Typically, trade associations do not coordinate their members' marketing activities (because doing so might have anti-trust implications), facilitate the secondment of personnel from one member to another, or allow their members to operate commercially under the association's trade name. Trade associations generally encourage do their members to publicize their membership, however, which serves to promote the association and helps the member market itself.

An alternative conceptualization of the Big Four might be the "global franchisors" model. Generally, a franchisor is liable to a third party for a franchisee's conduct when the franchisor exercises control over factors that gave rise to the third party's claim.[22] In the United States, the outcome in a specific case usually results from an application of both statutory provisions and case law.[23] In addition, the relevant franchise contract language and the parties' conduct will have a role in determining a legal outcome if the parties are unable to resolve the dispute themselves, either through direct negotiations or mediation.[24]

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[21] For example, see PwC's website at http://www.pwcglobal.com/Extweb/aboutus.nsf/docid/ECA175D939BDC94185256DD4003DFB69 (last visited Aug. 27, 2004), for a list of the members of PwC's "Leadership Team." The list consists of individuals based throughout the world. *Id*.

[22] Parker v. Domino's Pizza, Inc., 629 So.2d 1026, 1029 (Fla. Dist. Ct. App. 1993) (sufficient facts existed to raise triable issue of whether franchisor was liable to third party in tort because it retained sufficient control over means by which franchisee conducted business). *Contra* Murphy v. Holiday Inns, Inc., 219 S.E.2d 874, 878 (Va. 1975) ("regulatory provisions of the franchise contract did not constitute control within the definition of agency.").

[23] *See generally* Byron E. Fox & Henry C. Su, *Franchise Regulation – Solutions in Search of Problems?*, 20 OKLA. CITY U. L. REV. 241 (1995). *See also Murphy*, 219 S.E.2d at 494. Many other countries' legal systems set out specific requirements governing the franchisor-franchisee relationship; that is, the parties themselves do not have freedom of contract.

[24] *See* Alan J. Meese, *International Law & Federalism: What is the Reach of Regulation? Regulation of Franchisor Opportunism and Production of the Institutional Framework: Federal Monopoly or Competition between the States*, 23 HARV. J.L. & PUB. POL'Y 61, 63-67 (1999) (calling for more bargaining over the allocation of control between franchisors and franchisees to avoid inequities that may be caused by unforeseen applications of statutes); s*ee also* John L. Hanks, *Franchisor Liability for the Torts of Its Franchisees: The Case for Substituting Liability as a Guarantor for the Current Vicarious Liability*, 24 OKLA. CITY U. L. REV. 1, 2-3, 34-35 (1999) (contending that the law of franchisor liability for the

The resolution of a dispute between parties from different countries is often difficult. Inconsistencies in legal regimes and cultural factors make international franchising more complex than when the parties are from the same country. Given the globalization of the world economy, international franchising has increased, as well as the frequency of disputes between the parties. Where a member firm of a global accounting network is a party to a dispute, it is conceivable that a court may be required to examine the firm's relationship to the global association and possibly other member firms as well.[25]

The Big Four have chosen to organize in similar, though not identical, manners. Deloitte's member firms are integrated as an association under Swiss law.[26] E&Y maintains a more complex structure with its

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torts of their franchisees remains unsettled since courts have not achieved a consensus in their approach and concluding that insurance and the use of guarantees are better approaches to follow than finding fault based on theories of vicarious liability); Hong Wu v. Dunkin' Donuts, Inc., 105 F. Supp. 2d 83, 89-94 (E.D.N.Y. 2000) (finding that since franchisor did not exercise control over franchisee's premises, franchisor did not have a duty to ensure safety of franchisee's store); Pizza K., Inc. v. Santagata, 547 S.E.2d 405, 406-07 (Ga. Ct. App. 2001) (holding that franchisor was not contractually authorized to exercise control over its franchisee's pizza delivery service and thus was not liable for the negligence of franchisee's driver); Doubletree Hotels Corp. v. Person, 122 S.W.3d 917, 921 (Tex. Ct. App. 2003) (holding that hotel franchisor had no legal duty to hotel guest who was injured in franchisee's elevator); Kerl v. Dennis Rasmussin Inc., 672 N.W.2d 71, 79 (Wis. Ct. App. 2003) (franchisor was not found vicariously liable for franchisee's failure to supervise an employee who shot his former girlfriend).

[25] See DAVID O'REGAN, INTERNATIONAL AUDITING: PRACTICAL RESOURCE GUIDE (John Wiley & Sons, Inc. 2003) for a helpful reference guide on internal and external auditors of multi-national corporations, including valuable country-specific information. Mr. O'Reagan takes a multi-disciplinary approach when describing the auditing function, discussing cultural, economic, linguistic, organization, political, and regulatory factors that could have an impact on an audit. The Institute of Internal Auditors ("IIA"), an international professional organization engaged in the professional development and training of auditors, sponsored this Guide. IIA sets standards for the auditing industry and conducts research. IIA's website at http://www.theiia.org (last visited Aug. 27, 2004).

[26] Deloitte Touche Tohmatsu is a Swiss Verein ("Association"), and, as such, neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each member firm is a separate and independent legal entity operating under the names "Deloitte," "Deloitte & Touche," "Deloitte Touche Tohmatsu," or other, related names. *See* Deloitte's website at http://www.deloitte.com/dtt/home/0%2C2334%2Csid%25253D1000%2C00.html (last visited Aug. 27, 2004). The Association's individual members, not Deloitte Touche Tohmatsu Verein, provide services for fees to clients.

Code civil suisse §§ 60-76 (1988) set out the rules governing an association. http://www.uia.org/legal/app63.php (last visited Aug. 27, 2004). While some associations engage in economic-related activities, they are not permitted to provide services for fees with the goal of earning a profit. http://www.geneva.ch/genevaguidecommerciallaw.htm (last visited Aug. 27, 2004) (describing the scope of activities an association organized under Swiss law is permitted to engage in).

members independently working under the rubric of either English and/or Cayman Island companies with limited liability.[27] KPMG member firms

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On the Deloitte Professional Financial Services website, Deloitte describes the manner in which it purportedly operates:

> [T]he member firms of Deloitte offer clients a broad range of audit, tax, consulting, and financial advisory services. Our client service teams, under the leadership of a Lead Client Service Partner, help create powerful business solutions for organizations operating anywhere in the world. This integrated approach combines insight and innovation from multiple disciplines with business knowledge and industry expertise to help our clients exceed their expectations. Whether your company is just starting up or is on the verge of becoming a global powerhouse, our growth services can help you manage and sustain your company's growth.

http://www.deloitte.com/dtt/section_home/0,2331,sid%253D1001,00.html (last visited Aug. 27, 2004).

Furthermore, according to the website, Deloitte provides services such as legal, emerging markets, and risk consulting. *Id*. This language at a minimum could be viewed as misleading to potential clients as to who precisely is providing the services.

Using its "Global Site Selector," one can access over 100 countries and territories in which Deloitte has a global member firm. http://www.deloitte.com/dtt/home/0%2C2334%2Csid%25253D1000%2C00.html (last visited Aug. 27, 2004). Each member firm's office occupies part of the main website and has country-specific topics of interest to potential clients as well as contact information in at least two languages (typically the local language and English). *Id*.

[27] According to the disclaimer on the E&Y website:

> [E&Y] comprises a group of independent professional services practices which, together, operate in over 130 countries. These practices are members of either Ernst & Young Global Limited ('EYG') [an English company limited by guarantees] or Ernst & Young International, Limited ('EYI') [a Cayman Islands company limited by guarantee]. Some of the practices have ownership or operational links with others but, subject to this, the various practices are autonomous. They are legally separate from one another. Each practice is separately owned and managed and they have no liability for one another's acts.

http://www.ey.com/global/content.nsf/International/Ernst_&_Young_Global_disclaimer (last visited Aug. 27, 2004). Both entities do not provide professional services to clients.

> In addition to their interest in EYG or EYI, most Ernst & Young practices have an interest in EYGS LLP. This is an English limited liability partnership. Neither EYG nor EYI has any interest in it. Its business comprises solely the provision of services to members of EYG and EYI and certain related entities. Like EYG and EYI, EYGS does not participate in any way in client engagements of Ernst & Young practices and it does not control, or manage or have any ownership interest in, any Ernst & Young practice.

Id.

Nonetheless, more than 100 E&Y country practices operate "under a single global management structure and business strategy." *Id*. Significantly, Mr. Jim Turkey serves as E&Y Global's Chairman and CEO as well as Chair of the E&Y Americas Area. http://www.ey.com/global/content.nsf/International/Media_-_Our_Leaders (last visited Aug. 27, 2004). Like its competitors, E&Y identifies in detail the range of services its members offer and provides country specific details. http://www.ey.com/global/content.nsf/International/About_EY_-_Serving_Our_Clients (last visited Aug. 27, 2004). Sometimes a single E&Y member's territory consists of a number of countries (e.g. South–Eastern Europe). It appears that sometimes these entities will have also operate under the guise of a Swiss association.[28] Finally, PwC is an English limited liability company.[29]

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members or have contractual relations with other local entities. *See* http://www.ey.com/global/content.nsf/EYSEE/Home (last visited Aug. 27, 2004).

[28] The KPMG website states that KPMG International is a Swiss [Association] of which all KPMG firms are members. http://www.kpmg.com/ (last visited Aug. 27, 2004). KPMG International provides no professional services to clients. Each member is a separate and independent entity as describes itself as such (examples include, KPMG L.L.P., a U.S. limited liability partnership member of KPMG International, KPMG L.L.P., the U.S. member of KPMG International, or KPMG L.L.P., the U.S. Member of KPMG). *Id*.

According to its website, "KPMG is one of the leading providers of assurance, tax[,] legal, and financial advisory services. With a global approach to service delivery, KPMG responds to clients' complex business challenges with services that span industry sectors and national boundaries." *Id*. According to KPMG, its "assurance practice helps clients manage risk so they can focus on their core businesses. By intimately understanding each client's business, we can convert information into insights to uncover the hidden opportunities that can help clients improve efficiency and performance." *Id*.

The website further states that:

> KPMG's Tax and Legal practice is also focused on finding opportunities and leveraging them to the advantage of clients in the form of significant tax savings. Through tailored, innovative initiatives, the practice can help reduce a client's bottom-line expenses. Some KPMG member firms are authorized to perform legal services in their local regions. Our Financial Advisory Services practice provides valuable insights into how companies can grow and enhance their shareholder value. Corporate Finance and Transaction Services support clients through all phases of a transaction, from corporate strategy to post-merger integration. Corporate Recovery helps underperforming companies in turnaround situations and in rebuilding stakeholder confidence, while Forensic assists in protecting the reputation and integrity of our clients' business.

http://www.kpmg.com/services/ (last visited Aug. 27, 2004).

In addition, the KPMG website contains a country selector with information about the services offered by its members in more than 75 countries. http://www.kpmg.com/# (last visited Aug. 27, 2004). The country information on the page links from the main website is generally in the native language and English. *Id*.

[29] On its website, PwC describes how it functions as follows:

> [O]ur clients expect us to maintain and enforce consistently high standards of performance wherever we serve them and sign the PriceWaterhouseCoopers name. At the global level, we focus on core principles and practices that create and safeguard the quality exemplified in our brand in the networks that create organi[z]ational glue at every level, from individual client teams to global lines of service and industry expertise groupings.

http://www.pwcglobal.com/Extweb/aboutus.nsf/docid/0A1DA0D803D259F380256DD40042B07D (last visited Aug. 27, 2004).

Furthermore, the PwC website refers to its "global deployment" in the following terms:

> More than 1,000 partners and staff are currently on long-term placements designated as strategically important for client service or for strengthening PwC's global network. A third of these individuals are working on our major client accounts. In total, some 2,300 partners and staff—nearly 2 percent of the workforce of PwC firms in aggregate—are involved in assignments ranging from six months to five years in 76 countries. During 2003, we significantly increased short-term assignments in order to give more people the opportunity to build their international experience and to help clients respond to recent

Each of the Big Four calculates their members' fees or dues according to different formulae. These funds are apparently used to cover the expenses of the corresponding umbrella organization. On their websites, each of the Big Four boasts of having offices throughout most parts of the world (or of their global capabilities in general). Perhaps, it would be more accurate if they were to indicate that each of the Big Four has member firms located in many countries.[30]

> regulatory changes in the U.S. Our priorities for fiscal year 2004 include both increasing the mobility of those working on the largest international client teams and building the short-term assignment program to supplement the longer-term program. We measure our deployment performance by the number of secondments, their match with business needs, and assignees' satisfaction while on secondment and after repatriation.

http://www.pwcglobal.com/Extweb/aboutus.nsf/docid/F37540561069DB1780256DD40042DA33 (last visited Aug. 27, 2004).

[30] Tellingly on its website, through the use of the collective nouns, PwC intimates that it is a unified actor:

> PricewaterhouseCoopers provides industry-focused assurance, tax and advisory services for public and private clients primarily in four areas:
>
> - Corporate accountability
> - Risk management
> - Structuring and mergers and acquisitions
> - Performance and process improvement
>
> Our use of our networks, experience, industry knowledge and business understanding in each of those areas distinguishes the way we work. Within our own teams and with our clients, we are collaborative, open and direct. We are not content with standard solutions. We push ourselves and our clients to think harder, to understand all of the consequences and to consider new perspectives.

http://www.pwcglobal.com/Extweb/aboutus,nsf/docid/2034A92EA1272C7085256DD4003DA139 (last visited Aug. 27, 2004).

It is worth noting that the PwC website does not emphasize auditing services. http://www.pwcglobal.com. Apparently, PwC management is increasingly reluctant to take on new auditing clients as a consequence of increased risk of liability for improperly performed audits. This may present a problem for PwC since accounting firms have found that it was more profitable to sell non-audit services (though it is the auditing function that often provides the basis for the initial relation). Andrew Parker, *PwC taking a tough stance on potential clients: The economic slowdown has pushed the biggest of the big four firms to look beyond audit-driven revenues*, FIN. TIMES, Sept. 5, 2003, at 7.

Similarly, a page on the PwC website entitled "About Us: Foundations and Facts" reads as follows:

> PricewaterhouseCoopers seeks to provide service of consistently superior quality around the world. The diagram below summari[z]es the underlying principles that differentiate PwC firms from their competitors. It depicts in simple terms what an organi[z]ation of more than 120,000 people and $14.5 billion in aggregate revenues does. It describes why we do it, how we work together and our collective values. In this Global Annual Review, we show how the key elements of our shared strategy and culture serve as the foundation of the network of minds that we call Connected Thinking.

http://www.pwcglobal.com/Extweb/aboutus.nsf/docid/2034A92EA1272C7085256DD4003DA139 (last visited Aug. 27, 2004).

As noted above, each Big Four member firm appears to be an independent, profit-seeking legal entity. Taxation, ownership, personnel, and liability considerations are among the principal reasons for operating in this manner, rather than as a local partnership or as an integrated multinational enterprise headquartered in one jurisdiction with branches, representation offices, or subsidiaries in others.

For a variety of reasons, each of the Big Four strives to avoid being viewed as a unitary actor for legal purposes. There are several motivations for taking this approach to structure their operations and that of their member firms. First, it may be possible to second individuals who are not taxed by their home country when they are providing services abroad to another member firm. Second, individuals may be reluctant to operate in a truly multi-national entity since there may be problems with respect to licensing or regulatory compliance in some other form. Third, a major benefit of the Big Fours' legal structures is that if a Big Four member incurred some form of liability, particularly in the securities area, only that firm and the individuals directly involved with the matter (wherever based) would, in all likelihood, face legal and financial exposure. Of course, rules differ by jurisdiction with respect to professional liability to clients or third parties. They also vary as to whether one can be held liable for inadequate supervision or oversight of colleagues or subordinates.

Many Big Four member firms are "full service" entities; they do not simply specialize in traditional accounting or auditing services. Generally, they offer tax advice and management services, and in certain jurisdictions, engages in the practice of law.[31] With the lessening significance of national borders for international trade purposes, the increased role of multinational companies throughout the world, the ease in gathering and disseminating information, and the increased potential for government and regional regulation, it would become exceedingly complex to manage the provision of services if more than a single member worked for a particular client in a single jurisdiction. Collaboration of member firms would probably complicate the preparation of client and project management systems, not to mention create potential tensions arising from the allocation of fees to particular member firms, performance-based reviews, and the remuneration of individuals.

If different member firms were to provide services for fees directly under the aegis of one of the Big Four, additional complexities likely would

[31] In some cases, audits served as loss leaders for accounting firms capable of providing a broad range of services since in most cases non-audit work proved to be more "lucrative." *See* Michael Peel, *Big Five fees rise as audits drop: Survey shows shift to non-audit work as accounting firms 'seriously challenged' in US*, FIN. TIMES, Jan. 7, 2002, at 23.

emerge. For example, the member firms (and their personnel) might have conflicting interests and obligations to particular clients. The different member firms (and their personnel) also might be subject to different regulatory and ethical regimes.[32]

The demise of Arthur Andersen L.L.P. (a U.S. legal entity) triggered the collapse of the Andersen network of accounting firms, with some offices merging with long-standing competitors. Some new entities were established. In other cases, individuals or groups of professionals defected to existing entities prior to the liquidation of the local Andersen entity. If the member firms were indeed separate and independent, one might expect that one or more entities using the Andersen name might have continued as a going concern. Was the bad publicity from Enron so negative that it was inconceivable that the Andersen trade name could rise from the ashes?

According to the U.S. corporate governance paradigm, a corporation's management, board of directors, and audit committee will want an external audit to be performed properly. In practice, we know that this model has not always functioned in this manner.[33] To some extent, the Act may have addressed some of the major difficulties in this area (for example, by requiring the rotation of lead auditors and limiting the amount of money

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[32] University of Illinois Law Professor Larry Ribstein accurately described the process and consequence of the loss of "auditor independence," which he sees as an industry-wide phenomenon, not something endemic only to Arthur Andersen. Larry Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 13-15, 29-33 (2002). He called for greater reliance on contracts and market mechanisms rather than taking a regulatory approach, which he fears will prove costly and may not achieve its goals. *Id*. at 2-3. He blames the Enron scandal in part on the failure of Enron's audit committee to properly discharge its duties, lax accounting standards, and poor accounting work. *Id*. at 8-10.

According to Professor Ribstein:

> The accounting profession seems not to have adjusted to the transition from professional to profit-maximization norms. Like other auditing firms, Arthur Andersen pressed the business side, exhorting its partners to sell nonaudit services to audit clients and tying partner compensation to business production. In other words, auditing firms have used their auditing services, which firms must buy, as "loss leaders" to sell nonauditing services. Auditors' loss of independence in effect may have made them part of the management team in some cases. Years of working for the same client, along with prospects of joining the client's management and participating in its success, may have made auditors subject to the same pathologies that affected client management, including excessive optimism and loyalty, and reduced their concern for their auditing firm's reputation. Moreover, as the same people worked for the same clients from year to year, they may have found themselves bound to defend errors from earlier audits.

Id. at 9-10 (footnotes omitted).

[33] *See* RICHARD A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 43-44, 199, 243, 248-49 (Blackwell Publishing 2004).

that an accounting firm may receive for non-auditing activities).[34] Unfortunately, the Act's authors did not want to take more decisive steps, such as having a governmental body assign an auditing firm to a particular corporation or mandating that the auditing firm used be changed on a regular basis, though the latter issue is to be the subject of a study.[35]

The Enron case highlights that the interests of Arthur Andersen LLP, its overseas affiliates, Andersen Worldwide S.C. and their respective personnel, clients, and stakeholders diverged. While Enron represented a small percentage of all Arthur Andersen L.L.P.'s work, it was a large portion of the income of Andersen's Houston office.[36] Nonetheless, Andersen Worldwide S.C. and its member firms felt that the damage to their reputation was so severe that liquidation was the sole option pursued. The total disappearance of Andersen Worldwide S.C.'s member firms suggests that they may have considered themselves to have linked fates, perhaps because they were different components of a unitary actor.[37]

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[34] Although this article focuses in part on the impact of the Act on the performance of audits and on the Big Four in both the United States and abroad, reforming the auditing process is a subject being explored in many Organization for Economic Cooperation and Development ("OECD") countries. *See* OECD's website at http://www.oecd.org/department/0,2688,en_2649_34831_1_1_1_1_1,00.html (last visited Aug. 27, 2004) (OECD webpage entitled "Disclosure and Accounting Reform"). For example, in the United Kingdom, the Auditing Practices Board is soliciting reactions to proposed ethical standards covering the conduct of audits. Richard Fleck, *Questions of behavior: The Auditing Practices Board is asking for the profession's reactions to its list of proposed ethical standards for practitioners*, FIN. TIMES, Dec. 4, 2003, at 2. One influential United Kingdom Report called for increasing auditor independence. Andrew Parker, *Boardroom Shake-up: Call for in-house clampdown on co[z]y auditor relationships*, FIN. TIMES, Jan. 21, 2003, at 4; Andrew Parker, *Audit firms face threat to image of independence*, FIN. TIMES, Aug. 14, 2002, at 2.

[35] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 201-09, 116 Stat. 745, 771-75 (2002) (codified as amended in scattered sections of 15 U.S.C.A. (2004)).

[36] The total revenues for Arthur Andersen L.L.P. in the fiscal year ending August 31, 2001 were approximately $9.3 billion. John C. Coffee, *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 281 n.43 (2004). The Houston Office of Arthur Andersen L.L.P. estimated that Enron would generate approximately $100 million in the 2001 fiscal year. *Id.* Thus, prospective fees from Enron would amount to slightly more than 1% of total revenues. *Id.*

[37] Perhaps the accounting firms themselves are acknowledging through the settlement of cases what the courts have been reluctant to do to date. *See* Jonathan Birchall, *KPMG settles dispute with software maker for $115m*, FIN. TIMES, Oct. 8, 2004, at 15. According to the Financial Times, KPMG (New York) and KPMG Bedrijfsrevisoren (Belgium), agreed to pay a total of $115 million to settle a U.S. securities law class action lawsuit brought by investors in the Belgian corporation Lernout & Hauspie, bankrupt producer of speech recognition software. *Id.* Although Lernout & Hauspie was a client of KPMG Bedrijfsrevisoren, the latter apparently passed work on to its New York affiliate, giving rise to potential liability. *Id.* This again illustrates that the unity actor model may be appropriate to apply in cases of international auditing malpractice.

III. IMPROVING THE INTERNATIONAL ENFORCEMENT OF U.S. SECURITY LEGISLATION

According to David M. Stuart and Charles F. Wright of the Securities and Exchange Commission's Financial Fraud Task Force in the Division of Enforcement:

> The SEC's need to obtain work papers is addressed in part through the Securities & Exchange Act of 1934 ("Exchange Act") and the Securities Act of 1933 ("Securities Act"). These statutes empower the SEC to compel production of audit documentation from U.S. auditing firms through investigative subpoenas. Thus, as a matter of law, the SEC has the undisputed ability to obtain audit work papers of U.S.-based audit firms. However, audits of foreign issuers and multinational corporations include a significant amount of audit work performed outside of the United States by foreign affiliates of U.S. audit firms or by foreign auditors engaged specifically for an audit of certain foreign operations.[38] With increases in the globalization of American businesses and the increasing number of foreign issuers seeking access to the U.S. capital markets, audits of such concerns may involve the work of dozens of overseas audit firms.[39]

As noted by Messrs. Stuart and Wright, with the globalization of the world's economy and the increased likelihood that an issuer of securities will have operations abroad, the SEC's need to obtain documents not located in the United States has increased. The legislation in force at the time was often insufficient.[40] The following discussion identifies a major obstacle to the SEC's regulation of investment and enforcement activity:

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[38] In the past, the larger accounting firms often had the advantage in being hired to conduct audits for larger corporations. This is not surprising since these firms were likely to have a sufficiently large number of professionals to conduct such audits. In addition, they were more likely than their smaller competitors to have the international experience necessary to perform audits on multinational corporations. After the enactment of the Act, regulatory compliance work arising from the Act's new requirements has frequently proven more profitable than traditional audit work. Consequently, rather than precluding a variety of services, it is not surprising that the Big Four on occasion have chosen not to go after some audit work. This has created new opportunities for some medium and small accounting firms. *See* Karen Alexander, *For Small Accounting Firms, Scandals Have an Upside*, N.Y. TIMES, Feb. 24, 2004, at G11.

[39] David A. Stuart & Charles F. Wright, *The Sarbanes Oxley Act: Advancing the SEC's Ability to Obtain Foreign Audit Documentation in Accounting Fraud Investigations*, 2002 COLUM. BUS. L. REV. 749, 754-55 (2002).

[40] *Id*. at 755-67.

> The limiting language of Section 21 of the [Securities &] Exchange Act [of 1934] and Section 19 of the Securities Act [of 1933] normally does not present significant hurdles to the SEC obtaining documents from foreign subsidiaries of U.S. corporations, because the U.S. entity, as a legal matter, normally has possession, custody or control over the documents of its foreign subsidiaries. Accordingly, service on the U.S. entity is sufficient to obtain foreign documentation. However, the Big Five auditing firms are structured such that their foreign offices arguably escape SEC -- or, indeed, general U.S. -- jurisdiction. Each of the Big Five accounting firms, PricewaterhouseCoopers, Arthur Andersen, Ernst & Young, KPMG, and Deloitte Touche Tohmatsu is structured as an unaffiliated association of separate firms; the member firms are arguably separate legal entities. Accordingly, the U.S. offices of these firms have taken the position that they will not produce workpapers from their foreign affiliates pursuant to SEC subpoenas, arguing that they lack custody and control over such workpapers. This position is based upon a legal fiction. The Big Five accounting firms market themselves as united organizations that can coordinate their services around the world as though they are part of a single entity.[41]

Courts in the United States sometimes take a rather mechanical approach when applying Rule 45 of the Federal Rules of Civil Procedure to certain subpoenas.[42] For example, the Ninth Circuit Court of Appeals in *In re Citric Acid Litigation*,[43] applying a "legal control test," ruled that it could not compel Coopers & Lybrand L.L.P. (a U.S. entity) to produce documents in the possession of Societe Fiduciare Suisse Coopers & Lybrand (a Swiss entity), even though both were members of the Swiss Association, Coopers & Lybrand International.[44] The court noted that:

> [a]lthough members use the "Coopers & Lybrand" name, each firm is autonomous. Firms do not share profits or losses, nor do they have any management authority or control over other member firms. In addition, [Coopers & Lybrand International] does not exercise management, authority or control over member firms. Of particular relevance to the case at hand, [Coopers & Lybrand L.L.P.] does not have any economic or legal interest in [Societe

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[41] *Id*. at 758-60 (footnotes omitted).
[42] FED. R. CIV. P. 45 (2004).
[43] *In re* Citric Acid Litig., 191 F.3d 1090 (9th Cir. 1999).
[44] *Id*. at 1106-07.

> Fiduciare Suisse Coopers & Lybrand], and [Societe Fiduciare Suisse Coopers & Lybrand] has no such interest in [Coopers & Lybrand L.L.P.].[45]

The court ruled that it was proper for the magistrate judge and the district court judge to deny a motion to compel Coopers & Lybrand L.L.P. to produce documents that were not under its legal control, although they were in the possession of Societe Fiduciare Suisse Coopers & Lybrand.[46] The court noted that other circuits that had addressed whether to apply the unitary actor model to a major accounting entity's member firms had reached similar results.[47]

For example, in *Goh v. Baldor Electric Company*,[48] the U.S. District Court for the Northern District of Texas applied similar reasoning to that followed in *In re Citric Acid Litigation*. In *Goh*, the principal issue was whether Ernst & Young L.L.P. (the U.S. firm), a non-party to the case, could be compelled to produce documents allegedly possessed by Ernst & Young Singapore and Ernst & Young Thailand, both of whom were also non-parties.[49] After stating that the Fifth Circuit Court of Appeals had not "offer[ed] clear definitive guidance as to the appropriate definition of control," the court noted that:

> [t]he evidence presented [in this case] falls short of proving that Ernst & Young L.L.P. has control over the disputed documents. Ernst & Young L.L.P. was able to obtain some of the documents initially from the overseas entities through an honored request. However, Ernst & Young Singapore and Ernst & Young Thailand could have honored similar requests from another individual or entity if such requests were made. Other than shared membership in the common association of Ernst & Young International, Ernst & Young L.L.P., Ernst & Young Singapore, and Ernst & Young Thailand are separate entities. Ernst & Young L.L.P. is a United States limited liability partnership organized under the laws of the State of Delaware. Ernst & Young Singapore and Ernst & Young Thailand are separate general partnerships organized under the laws of Singapore and Thailand respectively. Each entity controls its own

45 *Id*. at 1106.
46 *Id*. at 1107-08.
47 *Id*.
48 Goh v. Baldor Elec. Co., No. 3:98-MC-064-T, 1999 U.S. Dist. LEXIS 209 (N.D. Tex. Jan. 13, 1999).
49 *Id*. at *3.

> resources, maintains separate profits pools, and holds different partners, members and management.[50]

The court also observed that the plaintiffs did not prove that Ernst & Young's Dallas office had access to all documents purportedly prepared by and in the custody of such foreign entities.[51] It did not regard as significant that all three entities used the same E&Y logo, noting that the accounting firms maintained separate books.[52] Furthermore, the court believed it to be significant that the plaintiffs did not demonstrate that Ernst & Young International, Ltd. "is under common ownership or that it issues a consolidated financial statement."[53]

Until recently, courts might have followed the approach taken by the U.S. District Court for the Southern District of New York in the securities fraud case *Cromer Finance Limited v. Berger*.[54] The plaintiffs in *Cromer* raised numerous claims against the accounting firms, including malpractice, breach of fiduciary duty, and aiding and abetting fraud.[55] The court performed a careful analysis of the plaintiffs' complaint, the defendants' promotional materials, and a confidential offering memorandum before determining whether the plaintiffs had the right to pursue their claims against each of the E&Y and Deloitte affiliates.[56] The court also studied the plaintiffs' allegations and the specific facts related to the alleged fraud revealed during the discovery process.[57] While the court held that it had personal jurisdiction over all the E&Y and Deloitte member firms named as defendants in the case, E&Y's and Deloitte's coordinated marketing efforts (e.g. the E&Y and Deloitte websites) were insufficient to render the member firms named as defendants liable to plaintiffs; there needed to be a showing of actual wrongdoing by a particular defendant.[58] The court permitted the case to proceed where the plaintiffs had made a *prima facie* case against certain of the accounting firms involved, E&Y (Bermuda) and Deloitte & Touche (Bermuda) for example.[59]

It is not clear that the same results would occur today. Understandably, legal developments frequently lag behind business practices. Courts and legislatures often fail to take into account the impact of technology and globalization on the manner of which businesses operate and

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[50] *Id*. at *10.
[51] *Id*. at *11-12.
[52] *Id*. at *8.
[53] *Id*. at *7-8.
[54] Cromer Fin. Ltd. v. Berger, 137 F. Supp. 2d 452 (S.D.N.Y. 2001).
[55] *Id*. at 466-67.
[56] *Id*. at 469-98.
[57] *Id*.
[58] *Id*. at 498.
[59] *Id*. at 476, 490.

thus the appropriateness of particular legal principles. Consequently, judicial precedent and statutory law may lead to unjust results in light of today's business practices.

This is cogently illustrated by Mr. Enrico Bondi's, (Parmalat Finanziaria SpA's government-appointed administrator) decision to file a lawsuit in the Cook County Circuit Court against Deloitte Touche Thomatsu, Grant Thornton International, and others in August 2004.[60] Mr. Bondi in part is applying the unified actor theory in seeking $10 billion in damages in connection with massive embezzlements and other improprieties at Parmalat, which contributed to its bankruptcy.[61] According to press reports, Grant Thornton International's affiliate in Italy and other members of its global network were Parmalat's principal auditors during 1990-99, before being replaced by Deloitte & Touche SpA.[62]

Grant Thornton International and Grant Thornton L.L.P., the latter a Chicago-based legal entity, both assert that they are not liable since Grant Thornton SpA, which is a separate Italian entity that has since been expelled from Grant Thornton's global umbrella organization, performed most of the auditing services in question.[63] Deloitte Touche Thomatsu raised a similar defense, that its Italian member firm, Deloitte & Touche SpA, and not Deloitte Touche Thomatsu, would be the proper defendant if there were a basis to the claim.[64] Mr. Bondi argues that Parmalat's losses could not have occurred without "the active, coordinated participation of these two accounting giants' offices around the world."[65]

The Act established the Board in part to examine whether or not current practices are sufficiently addressed by longstanding legislation.[66] As

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[60] Bloomberg News, *New Parmalat Group Sues Grant Thornton*, CHI. TRIB., Aug. 19, 2004, at 1. *See also* Tony Barber & Adrian Michaels, *Dollars 10bn writ over Parmalat audits*, FIN. TIMES, Aug. 19, 2004, at 26.

[61] *See supra* note 60.

[62] *See supra* note 60.

[63] Bloomberg News, *supra* note 60, at 1.

[64] Barber & Michaels, *supra* note 60, at 26.

[65] Bloomberg News, *New Parmalat Group Sues Grant Thornton*, CHI. TRIB., Aug. 19, 2004, at 1. Mr. Bondi also brought legal actions against Citigroup Inc., UBS AG, and Deutche Bank AG. *Id*. *See also*, Andrew Parker, *Doubts raised about auditor lawsuit: Administrator's case against accounts' US arms may be flawed*, FIN. TIMES, Aug. 20, 2004, at 23. While the consensus among academics seems to be that Mr. Bondi's suit will not succeed, it will focus greater attention on how international accounting firms operate. *Id*. An earlier lawsuit involving securities claims was also filed against Grant Thornton International and Deloitte Touche Tohmatsu in the U.S. District Court for the Southern District of New York by Southern Alaska Carpenters Retirement Trust, an institutional investor of Parmalat. http://www.accountancyage.com/News/1135973 (last visited Aug. 23, 2004).

[66] Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 7211 (Supp. 2004). Although both Houses of Congress enacted the Act with relatively little debate and by wide margins, the cost of compliance with its requirements is coming under increasing attack by some sectors of the

noted above, the Act explicitly grants to the SEC and the Board more extensive extraterritorial powers.[67] For example, section 7215(b)(2) of the Act concerns testimony and document production.[68] It begins by requiring "any firm or any person associated with a registered public accounting firm" having information deemed by the Board to be "relevant" or "material" to an investigation to testify or produce appropriate documents.[69] Paragraph D of this section envisions the Board as having the right to issue subpoenas pursuant to a procedure established by the Commission.[70] The Commission is to establish procedures permitting the Board to sanction persons for non-compliance with a request for testimony or documents.[71] These sanctions may include (i) a person being suspended or barred from being associated with a registered accounting firm, (ii) a registered accounting firm's right to operate being suspended or revoked, or (iii) other unspecified lesser sanctions.[72]

Section 7216(a)(1) of the Act states in pertinent part:

> Any foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer, shall be subject to this Act, and the Rules of the Board and the [Securities & Exchange] Commission issued under this Act in the same manner and to the same extent as a public accounting firm that is organized and operates under the laws of the United States, except that registration pursuant to section 102 shall not by itself provide a basis for subjecting such a foreign accounting firm to the jurisdiction of the Federal or State courts, other than with respect to controversies between such firms and the Board.[73]

Furthermore, sections 7216(a)(2) and (b)(1) of the Act provide that even if a foreign accounting firm did not prepare the audit itself but played a role in its

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business community. Dan Roberts, *Business leaders welcomed tighter rules after the scandals involving U.S. companies but now some claim the reforms are doing more harm than good*, FIN. TIMES, June 1, 2004, at 15. A number of studies illustrate this view, including a poll by the law firm Foley & Lardner. *Id*. The firm polled 100 public companies and about 20 of the respondents claimed that they were considering going private due to the high cost of complying with the requirements of the Act. *Id*. Similarly, Broadgate Capital Advisors and the Bank of New York conducted a survey of foreign corporations, 8% of which indicated that compliance with the requirements of the Act was a major obstacle to doing business in the United States. *Id*.

[67] 15 U.S.C.A. §§ 7214-15.

[68] *Id*. § 7215(b)(2).

[69] *Id*. § 7215(b)(2)(A).

[70] *Id*. § 7215(b)(2)(D).

[71] *Id*. § 7215(b)(4).

[72] *Id*. § 7215(b)(4)(A)-(B).

[73] Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 7216(a)(1) (Supp. 2004).

preparation, it consents in advance to the inspection of documents in its possession.[74]

Passage of the Act suggests that Congress intended the era where the courts blindly accept representations made concerning the management and operation of the international accounting firms come to a close. Consequently, it may become easier to pierce the corporate veil to support unitary actor theories in appropriate cases.[75]

IV. SHOULD ACCOUNTANTS BE ASSIGNED THE ROLE OF REGULATORY GATEKEEPER?

As noted by Professors Jonathan Macey and Hillary A. Sale:

> Traditional partnership governance structures did not include an explicit duty to monitor one's peers, the fact that partners were vicariously liable for each other's professional negligence created strong incentives to monitor one another. The introduction of the L.L.P. [and other limited liability entities] eliminated that incentive, leaving us to question why Arthur Andersen's top management applauded itself when it fired David Duncan, the lead partner on the Enron audit, and placed three other partners involved with the firm on administrative leave. Andersen justified firing Duncan by saying that he violated the firm's policies requiring "reasonable good judgment." But reasonable good judgment also would have required better oversight over the decisions being made by the people in charge of the Enron account by other Andersen partners. Better systems of internal monitoring and control are necessary to ensure that more Enron-type situations will not occur. Those systems,

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[74] *Id*. § 7216(a)(2)-(b)(1).

[75] Some civil law countries provide in their corporate law that if a subsidiary has insufficient assets to cover its financial obligations for transactions or paying particular creditors during liquidation, its parent company has secondary liability. *See, e.g.*, GK RF, arts. 105-06 (1999). A member firm of a particular Big Four family is not a subsidiary in the conventional sense. Nonetheless, if a court were to deem the coordinating entity of a Big Four member to have the capability to control the actions of a member firm, it might accept the argument that all members firms of a Big Four family are collectively a unitary actor. This may have significance irrespective of where a case is brought due to conflict of law rules. Consequently, the court may not have to examine the issue of whether it is appropriate to pierce the corporate veil of a member firm or parent.

> however, are compromised by the limited liability structure of Andersen and the other auditing companies.[76]

Originally, most accounting firms were organized into general partnerships. In the 1990s, many accounting firms reorganized as limited liability entities. This had significant consequences.[77] Simultaneously, accounting firms became less concerned about the quality of their audits.[78]

The importance of an auditor having limited liability in the event of a claim comes into play in only a number of circumstances, including (i) where his auditing firm does not have an active professional liability insurance policy in place (either it did not procure the necessary insurance or the company issuing the insurance is unable to pay), (ii) where the financial consequences of the actions or omissions giving rise to the malpractice claim exceed the insurance policy's limits, and/or (iii) where the relevant actions fall into one of the exclusions to the firm's malpractice insurance policy.

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[76] Jonathan Macey & Hillary A. Sale, *Lessons from Enron, How did Corporate and Securities Law Fail? Observations on the Role of Commodification, Independence and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1169 (2003).

[77] Professors Jonathan Macey and Hillary A. Sale describe how this development produced:

> dramatic changes in the nature of partnership governance. Where '[a] basic principle' of the general partnership requires individual partners to be liable for any partnership obligations that exceed the assets of the partnership, [all forms of limited liability entities generally eliminate the risks posed by] vicarious liability by limiting liability to partnership assets instead. Although the exact form of [limited liability entity] liability varies with jurisdiction, the basic concept of eliminating personal liability for partners who do not control or supervise the wrongdoers is consistent across states.
>
> The move from [a] general partnership form to a [limited liability] form creates disincentives to monitor. [Applicable statutes usually] impose personal liability on partners engaged in the supervision of the professional activities of others, eliminating the incentive to supervise one's peers. As a result, professionals who might have provided advice and counsel to their colleagues under the general partnership form may resist doing so . . . 'to avoid taking on potential liability for the work.' [T]hese provisions undermine partners' incentives to engage in supervisory work. Although the market could develop contractual devices to deal with this perverse incentive problem, there is no evidence that such solutions have been found.

Id. at 1171-72.

[78] *Id*. at 1172. Professors Jonathan Macey and Hillary A. Sale believe that:

> client satisfaction and the concomitant client capture problem exacerbated the limited liability problem. As client satisfaction, rather than maintenance of the reputation of the accounting firm, became the paramount objective for the individual audit partners assigned to particular accounts, the interests of individual audit partners diverged from those of the firm as a whole. Unfortunately, it is those individual audit partners, rather than 'the firm,' who must be relied upon to make specific accounting decisions for individual clients.

Id. at 1177.

Generally, each of the Big Four member firms is organized in a business form having limited liability. Depending on the law of the relevant jurisdiction in which the member is organized, each partner, shareholder, or member, depending on the legal form (as well as other professionals operating under the auspices of the entity), has liability for his own improper acts or omissions. Such acts and omissions may include supervisory duties, the extent of which is not always clear.

Since accounting firms began to organize as limited liability entities such as Professional Corporations (P.C.s), Limited Liability Partnerships (L.L.P.s), and Limited Liability Companies (L.L.C.s), significant questions have been raised and remain unanswered. To what degree is an accounting professional vicariously liability for the acts of one's colleagues? This is not merely an academic question nor, given the Act's extraterritorial reach, is it a topic that only concerns U.S. entities and individuals.

By allowing individuals to create member firms throughout many countries to offer auditing, accounting, and other services, most have accepted that it is possible to contain liability to a particular jurisdiction and a limited number of individuals. In most instances, claims would seem possible only against a single accounting firm that is a member of one of the Big Four (and the relevant personnel working on the matter either in a malpractice or third-party claim context), as well as other entities and individuals that may be held liable as a result of their actions. In most instances, it would also seem that other than its insurance, the accounting firm entity would risk only the loss of the value of its assets and any undistributed revenues. On first impression, individual professionals would not have vicarious liability. This result can have undesirable consequences for the public and should be scrutinized.

The judiciary may be in a position to denominate liability, on first impression, as "vicarious" or "direct," for example in the supervisory context. "Supervision" is a flexible term. It could include not only direct supervision of another person, but can also cover "oversight" in the sense of participating in accounting firm management bodies or even the monitoring activities of such bodies (such as receiving agenda and minutes). Permitting an accountant to avoid involvement in the management of an accounting firm in which he has an ownership interest could be harmful to the public.

A narrow view of "supervision" creates an incentive for accountants with ownership interests not to serve on any of the firm's governing bodies, since by doing so, they could be found to have direct liability for another's malpractice. Fear of liability for supervisory activities[79] encourages accountants to be passive when wrongdoing might be suspected.

These are difficult issues with significant implications. Are accountants to be permitted to benefit from marketing under a Big Four name or the association's website, but be protected by disclaimers either on the website or an engagement letter? What information does an accountant need to convey to the individual retaining him on behalf of a corporation? Should there be mandatory disclosures not only to members of a corporation's audit committee, but to shareholders as well? What about potential purchasers of a corporation's securities?

Does an accountant practicing as a member of an auditing firm have the obligation to ensure that the practices of both the firm and profession are observed; should participants have a responsibility to play a role in the due diligence on potential hires?

Some statutes permitting professionals to practice in a limited liability form on their face offer "full shield" protection against vicarious liability, while others offer only "partial shield."[80] Even if there is "full shield" protection, it is not clear whether an accountant practicing as part of an accounting firm has certain implied duties, such as:

(i) supervising junior accountants and staff, even when the accountant is not necessarily the individual in charge of a matter;

(ii) ensuring that the firm's accountants are competent to handle the matters they are working on;

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[79] It should be kept in mind that some state statutes or case law are explicit that general supervisory responsibilities are insufficient to give rise to malpractice liability. Generally, L.L.P. statutes provide for limited liability if the relevant obligation of the entity occurred when the L.L.P. was in existence, irrespective of (i) when the negligence or wrongful act(s) took place or (ii) whether it has been liquidated. *See* Allen G. Donn, *Emerging Issues of L.L.P.s/L.L.C.s for Law Firms*, 4-6 (unpublished, but presented at the American Bar Association's Committee on Lawyers Professional Liability's National Legal Malpractice Conference, Apr. 28-30, 2004).

Many of these statutes protect partners from liability for all partnership debts, and obligations ("full shield" protection), while others only protect an "innocent" partner from vicarious liability for negligence claims or misconduct of a partnership's agent ("partial shield" protection). Susan Saab Fortney, *High Drama and Hindsight: The L.L.P. Shield, Post-Andersen*, BUS. L. TODAY, Jan./Feb. 2003, at 128. According to Professor Susan Fortney, Associate Dean and Texas Tech University Professor of Law, partners in both partial and full liability statutes are liable for their own negligence as well as other improper acts and omissions. *Id*. Furthermore, "most L.L.P. statutes also provide some degree of personal liability for supervisory partners." *Id*.

[80] Fortney, *supra* note 79, at 128.

(iii) seeing that corporate formalities are followed[81] and tax filings are properly made; and

(iv) creating a climate that encourages justified "whistle-blowing."

The range of unresolved questions in this area is numerous and will probably vary by jurisdiction.

At the same time many accounting firms reorganized into limited liability entities there was an increased emphasis on profitability. This process contributed to a thinning of the ranks of partners who did not have a significant client base and many senior accountants who were not yet eligible to be equity holders in the firm.[82] In many cases, the quality of the auditing work suffered with this loss of expertise.

Individuals who may lack sufficient skills to properly carry out their duties may be given the responsibility to gather the data for the external audit. At the same time, the principal oversight responsibility for the audit may be that of a person who has a major financial stake in the relationship with the corporation being audited (and may even have been a client on other profitable matters). This is arguably justified since this individual may be most familiar with the company undergoing the audit. This phenomenon has been labeled "auditor capture."[83] Given the significance of human relationships in client development and the importance to a corporation of

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[81] Failing to observe corporate formalities, particularly when offices abroad can produce unforeseen liability problems, leads to piercing of the corporate veil as part of the plaintiff's process in advancing its unitary actor theory to recover damages. The undercapitalization of both U.S. and foreign limited liability entities also strengthens arguments to pierce the corporate veil and reach the assets of all individual accountants within the auditing firm.

[82] Many of these individuals leave to join smaller accounting firms that are less likely to perform external audits for the largest corporations.

[83] Jonathan Macey & Hillary A. Sale, *Lessons from Enron, How did Corporate and Securities Law Fail? Observations on the Role of Commodification, Independence and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1168 (2003). This problem has become more acute in recent years. According to Professors Jonathan Macey and Hillary A. Sale:

> the balance of power between accounting firms and their clients has shifted dangerously away from the equilibrium imbedded in the market model and back in the direction of the companies the accounting firms are supposed to monitor. This change threatens to undermine the investing public's basic faith in the quality of financial reporting. If investors think that there is a risk that the books do not reflect the nature of the companies' businesses and the risks associated with the investment, they will not invest in companies.

Id. at 1169.

being given a "clean bill of health," the incentives for a firm conducting an audit not to serve as an aggressive watchdog are great.[84]

Many claims against auditing firms do not exceed insurance policy limits. Consequently, where there is a claim for an amount within policy limits, the insurer and the insured need to assess whether there is in fact liability and whether to settle or try the case. In the typical case (i.e. for less than the policy's limits), the plaintiff sues both the individuals performing the audit and the auditing firm. In such circumstances:

(i) the individual accountants/auditor(s) being sued may feel that the case is without merit; preserving one's reputation may be a central concern and thus the accountant/auditor(s) may not want to settle the case;

(ii) the auditing firm's management is concerned both with preserving the firm's and its personnel's reputations. Nonetheless, it may be sensitive to the potential disruptive effects of litigation on the auditing firm's operations and morale, and the potential impact on its ability to attract (and retain) clients and personnel. In addition, the auditing firm's management may be concerned about exhausting its insurance policy's limits on litigation, leaving less money for settlement of this or other cases. Under such circumstances, the auditing firm's management is seldom as concerned about the foreseeable consequences for the auditors who have been sued; and

(iii) the insurer typically wants to minimize its costs and may be indifferent if policy limits are spent on litigation or settlement.[85]

It is unlikely that any court would find an individual accountant whose only liability arises from the performance of management duties to have major exposure unless the individual has engaged in egregious conduct.

Nonetheless, even if an auditing firm's partner did not take an active day-to-day role in the firm's management, he probably participated in the

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[84] *Id*. at 1168.

[85] If these scenarios were to become actual cases, the outcome will in part depend on whether the relevant state statute offers a full or partial shield. *See* Fortney, *supra* note 79, at 128.

selection of the firm's management, executive, recruiting, training, or other committees. These committees might be viewed as performing services (almost certainly for compensation) on behalf of the firm's managers. Section 2 of the Restatement (Second) of Agency provides:

> (i) a "master" is a principal who employs an agent[86] to perform service in his affairs and who controls or has the right to control the physical conduct of the other in the performance of the service;
>
> (ii) a "servant" is an agent employed by a master to perform service in his affairs whose physical conduct in the performance of the service is controlled or is subject to the right to control of the master; and
>
> (iii) an "independent contractor" is a person who contracts with another to do something for him but who is not controlled by the other or subject to the other's right to control with respect to the physical conduct in the performance of the undertaking. He may or may not be an agent.[87]

While an individual partner in an auditing firm, in most cases, is not in a position to control a committee member's performance, usually the partners collectively have such power (and thus an individual partner may have a proportionate responsibility equal to his holdings to exercise his power).[88] In general, an agent acting on behalf of a principal within the scope of his assigned duties gives rise to the principal's liability.[89]

> [86] To establish that an agent has apparent authority to act on the principal's behalf, it must be shown (1) that the principal has manifested his consent to the exercise of such authority or has knowingly permitted the agent to assume the exercise of such authority, (2) that the third person knew of the facts and, acting in good faith, had reason to believe, and did actually believe, that the agent possessed such authority, and (3) that the third person, relying on such appearance of authority, has changed his position and will be injured or suffer loss if the act done or transaction executed by the agent does not bind the principal.

3 AM. JUR. 2D *Agency* § 78 (2004) (footnotes omitted).

[87] RESTATEMENT (SECOND) OF AGENCY § 2 (1958).

[88] University of Michigan Law Professor Nina Mendelson argues that shareholders who in fact exercise control over a corporate entity should not enjoy limited liability. Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 COLUM. L. REV. 1203, 1208, 1271-79 (2002). As noted above, accountants can have a variety of relationships giving rise to liability. For example, when acting in a consultative role, an accountant might have both contractual and tort liability (e.g. malpractice, breach of fiduciary trust, and constructive fraud). When acting in the capacity of an auditor, liability will most likely be based on tort theories. In her article, Professor Mendelson argues that shareholders

If all owners of an accounting firm believed that management responsibility could not be delegated, it is likely that fear of potential liability might motivate them to ensure that applicable norms and standards are followed and quality control procedures are observed. Rather than merely being individuals who shared certain expenses and space, they might operate as gatekeepers against corporate abuses or securities violations. Unlike lawyers who have fiduciary relations to their clients, accountants acting as public auditors have a different role. They are the first line of defense in protecting the public interest. Congress (and state legislatures) should investigate what additional requirements could achieve this result. At the top of the list is to re-examine the protections granted accountants from vicarious liability when their firms are serving as public auditors.

V. CONCLUDING OBSERVATIONS

It is reasonable to expect that following the public outrage over corporate scandals, the enactment of the Act, and the SEC's issuance of new rules and regulations courts will give greater scrutiny to the role of auditing firms and their auditors. The individual accountants who may have not have detected the transgression, and in some cases facilitated it, are likely to face greater legal liability in the future when their clients (or their clients' creditors) experience material losses.

In today's global marketplace, unilateralism in law enforcement will not achieve the desired results. The SEC and other components of the U.S. government must work closely with their counterparts to improve not only the applicable rules in each jurisdiction, but also to make more effective enforcement actions.

This cannot be accomplished without laws and regulations consistent with the business model followed by the international accounting industry. Until the risk of liability for actions of colleagues becomes real for accountants practicing under the auspices of the Big Four, this is unlikely to be accomplished.

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with a capacity to control corporate behavior should have a proportionate share of liability for torts. *Id*. at 1271. Such a system might reduce risky behavior on the part of corporations. *Id*. at 1281-85.

[89] *See* RESTATEMENT (SECOND) OF AGENCY, chs. 1-3, 6-7 (1958).