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AUDITORS AS GATEKEEPERS: THE EUROPEAN REFORM OF AUDITORS' LEGAL REGIME AND THE AMERICAN INFLUENCE

*José João Montes Ferreira-Gomes**

I. INTRODUCTION

Tyco – and Europe – with Royal Ahold, Skandia Insurance of Sweden and finally Parmalat – have awoken the world to the need for reform of company and financial The financial scandals that swept the United States – such as Enron, WorldCom and law. Studies suggest that the main causes of the debacle in the United States were the increasing incentives for managers to commit fraud and 'gatekeepers' to be lenient, together with the evolution of the GAAP towards a rule based financial reporting system. In Europe the causes of the scandals have not yet been fully determined, but one question was also heard above the rest: where were the gatekeepers? As for the reporting system, it has been said that the European principles based systems are less likely to allow fraud on such a grand scale, but Parmalat proved that much has to be done in Europe as well.[1]

In midst of the crisis, one overwhelmingly simple conclusion strikes me: no matter how greedy corporate officers may have been (or in the European case, even controlling shareholders), none of these frauds would have been possible without the acquiescence of 'gatekeepers'. The incentives of entrepreneurs to commit fraud are always strong, but gatekeepers' incentives to withhold their support to wrongdoers are meant to be equally strong. 'gatekeepers' are supposed to protect their reputation, to protect investors who rely on their word and to say "no" to their fraudulent clients.

We have fully entrusted these 'gatekeepers' with our safety and rested on our laurels. We may now conclude that this was not a wise decision. As Donald Langevoort states, "the 'expectations gap' is real: securities regulation is far from any assurance of corporate transparency, delivering neither as much protection as many investors assume nor as much as is optimal."[2] It is true that 'gatekeepers' may not fully guarantee corporate transparency, but they should do so to a certain degree. An interesting question is whether maintaining a good reputation is a sufficient incentive to protect investors. Just as this was once a generally accepted premise, nowadays it tends to be rejected.

* Ph.D. candidate at the Universidade Católica Portuguesa and associate of Uría Menéndez (Lisbon). This Note represents, with slight changes, the essay submitted in partial fulfillment of the requirements for the degree of Master in Laws at the Columbia University School of Law, in April 2004. Some of the changes reflect the amendments to the Proposal for a Directive on statutory audit of annual accounts and consolidated accounts (presented by the European Commission on March 15, 2004) proposed by the Committee on Legal Affairs of the European Parliament in the Draft Report prepared by Bert Doorn. This Note greatly benefited from comments by Professor Kathrina Pistor, to whom I express my gratitude for her support and guidance.

[1] In this matter, the priorities seem to be the harmonization of European accounting standards through the International Accounting Standards and the specification of group auditors as fully responsible for the consolidated financial reports.

[2] Donald C. Langevoort, Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda, 48 Vul.L. Rev. 1139.

The United States reacted to the scandals by enacting the Sarbanes Oxley Act (Public Company Accounting Reform and Investor Protection Act of 2002[3]), described by President Bush as incorporating "the most far-reaching reforms of American business practices since the time of Franklyn Delano Roosevelt."[4] Meanwhile, the European Union was already involved in a profound reform of corporate law in Europe – seeking the harmonization of the different Member States' systems – and the creation of a single capital market, but the outbreak of US scandals and the fear of similar European scandals created a new incentive to boost the reforms outlined in the action plans for Financial Services[5] and Company Law[6]. While the US response (with the enactment of the Sarbanes Oxley Act) was considered precipitated[7], many fear that EU's response will be too slow. The causes of these scandals have been analyzed in Europe by the High Level Group of Company Law Experts[8] and are reflected in the implementation of the various steps of the aforementioned action plans. The hope for a timely reaction now rests with the implementation of the Lamfalussy Process.

In this Note I seek to assess the role of auditors as 'gatekeepers'; what has been done to improve this role on both sides of the Atlantic and what is still to be done; and how the measures adopted and discussed in the United States with and following the Sarbanes Oxley Act have and will influence parallel reactions by the European Union. In particular, I shall address the issues that in my opinion have the most significant impact on the role of auditors as gatekeepers: auditor independence and liability to investors.

Moreover, although the discussion in Europe embraces the role of auditors in the protection of the company as an ongoing enterprise – considering the interests of all those who rely on the company such as shareholders, employees and creditors – my analysis is limited to the role of auditors as 'gatekeepers', i.e. in the protection of investors.

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3 15 U.S.C. §7201 et seq., 107 Pub. L. No. 204, 116 Stat. 745.

4 See Signing Statement of George W. Bush, July 30, 2002, available at the web site of the White House, http://www.whitehouse.gov/news/releases/2002/07/20020730.html.

5 Financial Services: Implementing The Framework for Financial Markets: Action Plan, adopted by the European Commission on May 11, 1999, COM (1999) 232, 11.05.99: "concentrates on ensuring deep and liquid European capital markets, which serve both issuers and investors better and the removal of remaining barriers to cross-border provision of retail financial services in order to ensure consumer choice while maintaining consumer confidence and a high level of consumer protection."

6 Commission Communication on Modernization of Company Law and Enhancement of Corporate Governance in the European Union - A Plan to Move Forward, May, 21, 2003, COM (2003) 284.

7 See e.g. Michael A. Perino, Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002, Columbia Law and Economics Working Paper No. 212, at 2, available at http://ssrn.com/abstract=350540 [hereinafter "Perino, Enron's Legislative Aftermath"], stating that "as the political firestorm increased and the Dow Jones Average plunged, there was clearly a sense in Washington that Congress had to do something (anything) and do it fast".

8 Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, November 4, 2002. Available at the website of the European Commission, http://europa.eu.int/comm/internal_market/en/company/company/modern/consult/report_en.pdf.

II. GATEKEEPERS AND GATEKEEPING

The Securities and Exchange Commission ("SEC")[9] and securities practitioners commonly use the expression 'gatekeepers' when referring to "independent professionals who serve investors by preparing, verifying or accessing the disclosures that they receive."[10] Put simply and using the words of John Coffee, "the gatekeeper model is a third party enforcement strategy that relies on the fact that it may be easier to deter a third party who has little to gain than an entrepreneur who has a significant stake in a questionable transaction."[11] The typical examples of 'gatekeepers' include auditors, debt rating agencies, securities analysts, and investment bankers. The inclusion of securities lawyers in this list has been widely discussed in the United States.[12]

Ronald J. Gilson and Reinier H. Kraakman were probably the first to use the concept of 'gatekeeper'[13], although not naming it, when in 1983 they presented investment bankers as "reputational intermediaries."[14] Their description focused on the role of investment bankers in achieving market efficiency:

> If information costs are high enough, the issuer might not realize any return on its investment in developing a better security, and market inefficiency would operate as a complete barrier to innovation. ... Our approach to market efficiency leads to considering the role of the investment banker as an agent for economizing on information costs. … The investment banker rents the issuer its reputation. The investment banker represents to the market … that it has evaluated the issuer's product and good faith and that it is prepared to stake its reputation on the value of the innovation.

The description of 'gatekeepers' as reputational intermediaries was the first step in the development of the concept of gatekeepers. As described by Ronald Gilson and Reinier Kraakman in the above quoted text, corporations sought the services of reputational intermediaries, regardless of any legal obligation, who could rent their reputation – their most valuable asset – to overcome market inefficiency associated with the costs of analyzing the information disclosed in a given transaction.

The second step in the development of the concept of 'gatekeepers' is explicit in the definition presented in 1984 by Kraakman, who defined 'gatekeepers' as private third parties who can disrupt misconduct by withholding their support to

[9] See e.g. Securities Act Release No. 33-7870 (June 30, 2000) (noting that "the federal laws .... make independent auditors 'gatekeepers' to the public securities markets") and Securities Act Release No. 33-7314 (July 25, 1996) (discussing "The Role of Gatekeepers in Maintaining the Quality of Disclosure").

[10] John C. Coffee, Jr., Symposium: Regulating the Lawyer: Past Efforts and Future Possibilities: The Attorney as Gatekeeper: An Agenda for the SEC, 103 Colum. L. Rev. 1293, at 1296 [hereinafter "Coffee, The Attorney as Gatekeeper"].

[11] John C. Coffee Jr., The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence the Governance of Accounting, Columbia Law and Economics Working Paper No. 191, at 8, available at the SSRN website (http://papers.ssrn.com/paper.taf?abstract_id=270944) [hereinafter "Coffee, The Acquiescent Gatekeeper"].

[12] See José Ferreira Gomes, The Role of Lawyers as Gatekeepers, unpublished paper on file with the author.

[13] Following an assertion of John Coffee. See Coffee, The Acquiescent Gatekeeper, supra note 11, at 8.

[14] Ronald J. Gilson and Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, at 613-622.

wrongdoers.[15] In his historical article "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy," Kraakman highlighted the power of 'gatekeepers' to disrupt corporate misconduct, whether based on private incentives or legal rules. Furthermore, he analyzed the costs of imposing gatekeeping liability over third parties with and without private incentives.[16]

Considering the need to protect investors in an open market, legislators felt the need to better control the information disclosed by public companies to the market, imposing legal obligations regarding the certification and assessment of the information disclosed. The natural solution was the imposition of such legal obligations over independent third parties with private incentives to perform such duties. Independent third parties have their own assets – especially their reputation – and corporate identity at stake, which further ensure their ability to disrupt corporate misconduct. Private incentives – such as the contractual obligations mentioned above in the case of investment bankers – reduce the costs of the legal obligations, therefore facilitating a more efficient solution.

In a third step in the development of the concept of gatekeepers, John C. Coffee narrowed the definition presented by Kraakman, which he considered to be too broad. In order to highlight the deterrence capacity of the 'gatekeeper' and whether it possesses reputational capital,[17] Coffee defined 'gatekeepers' as reputational intermediaries who provide verification or certification services to investors.[18]

Following this evolution and for the purposes of this Note, I define 'gatekeepers' as (i) independent third parties who (ii) pledge their reputation and remaining assets (iii) when verifying or certifying information (iv) to comply with legal requirements or minimize excessive transactional costs. Thus, the auditor is generally recognized as the classic example of a gatekeeper: he is an independent third party who pledges his reputation when certifying a company's financial statements filed with the supervisory authority. Furthermore, by withholding his support, he disrupts all unlawful transactions reflected in such statements.[19]

Having defined the concept of gatekeeper, it should be noted that history tells us that reputation is not always a sufficient motivation and should be – in certain cases – supplemented by suitable mechanisms for "gatekeeper liability". As Reinier Kraakman wrote in 1986, the term "gatekeeper liability" refers to "the legal regimes

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[15] Reinier H. Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. Econ. & Org. 53, 54 (1986) [hereinafter "Kraakman, Gatekeepers"]. See also Reinier H. Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857, 888-96 (1984) (evaluating gatekeeper liability).

[16] Reinier Kraakman distinguished between "market" gatekeepers, who face powerful private incentives to prevent misconduct, especially reputation, and "public" gatekeepers, who do not. The first include accountants and investment bankers. The example for public gatekeeper regimes was an employer's duty to screen for illegal aliens or a doctor's duty to monitor for drug abusers. Kraakman, Gatekeepers, supra note 15, at 61.

[17] John Coffee asserted that this broader definition would potentially hold liable persons who sold pencils to Al Capone's gang on the grounds that one could not run a brewery and tavern business without using pencils to keep records. See John C. Coffee Jr., Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, Columbia Law and Economics Working Paper No. 237, at 11. Available at http://ssrn.com/abstract=447940 [hereinafter "Coffee, Gatekeeper Failure"].

[18] Coffee, Gatekeeper Failure, supra note 17, at 12.

[19] Assuming that all auditors contacted by the corporation refuse to certify the misleading statements.

that impose civil or criminal sanctions on gatekeepers that fail to withhold support" to wrongdoers.[20]

I consider below what has been done in both the United States and Europe to enhance these incentives and what could be done to make them function more effectively in practice.[21]

III. THE SARBANES-OXLEY ACT

A. General Overview

The Sarbanes Oxley Act ("SOX") was the reaction of the US Congress to the scandals that swept the country in 2001 and 2002 and heightened the subsequent financial crisis. As the frauds caused a national hysteria in the United States, investors and other market players demanded a strong governmental intervention, strong enough to stabilize the markets and reinforce public trust in them. Senator Paul S. Sarbanes and Congressman Michael G. Oxley promoted this initiative that lacked support even after Enron as auditing firms effectively exercised their lobbying powers. However, the WorldCom case diluted all remaining resistance in Congress and the bill was finally approved by an overwhelming majority that reflected the national support for such a strong federal intervention. Various critics have targeted the SOX. Some condemned Congress for its hasty reaction and others complained that Congress did not go far enough on the need for reform.

B. What's New?

To better understand the new rules applying to auditors in the United States and in Europe, it is important to consider them in light of the recent and current dramatic reforms. Therefore, I consider below the US reforms implemented by the SOX and, in section 0, the corresponding European reforms.

The first major reform implemented by the SOX was the creation of the Public Company Accounting Oversight Board to register, regulate, inspect, and investigate public accounting firms and associated persons thereto.[22]

The second major reform was the reinforcement of auditors' independence, forbidding auditors to provide certain types of non audit services,[23] requiring pre-

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[20] Kraakman, Gatekeepers, supra note 15, at 54.

[21] Gatekeeper liability is a compromise solution between primary enforcement and more onerous solutions such as whistleblowing duties. Gatekeeper liability makes sense only when primary enforcement is ineffective or too costly and mandatory whistleblowing necessarily carries higher costs. Reinier Kraakman better defines these costs as follows: "Gatekeeping threatens to inflict the opportunity cost of foregoing a profitable (or pleasurable) activity on the enforcement target. By contrast, whistleblowing typically imposes not only this cost but also the additional costs of legal defense, reputational loss, and possible penalties or civil damages. If only wrongdoers bore these costs, we might not mind. But to the extent that even erroneous or abusive whistleblowing can trigger the same losses, whistleblowing leaves all regulatory targets at the mercy of their private monitors. Whatever their actual intentions, then, all regulatory targets have a powerful incentive to withhold information from potential whistleblowers and to refrain from transacting with anyone of suspect loyalties. Conversely, these responses create a matching incentive for putative whistleblowers to avoid actual whistleblowing at any cost." Kraakman, Gatekeepers, supra note 15, at 59.

[22] Following the model set forth to the National Association of Securities ("NASD") oversight of the brokerage industry. See sec. 101 of the SOX.

approval of the audit committee for other non audit services,[24] imposing audit partner rotation every five years,[25] imposing an obligation to report to the Audit Committee all critical accounting policies, alternative treatments of financial information and other material written communication with the management,[26] and reducing conflicts of interest, forbidding auditing firms to perform any audit service if certain officers of the issuer were employed by that audit firm and participated in any capacity in the audit of that issuer in the preceding year.

The third significant reform was the strengthening of corporate responsibility, requiring that public companies' audit committees be composed solely of independent directors and strengthening its powers and responsibilities,[27] requiring chief executive officers ("CEO's") and chief financial officers ("CFO's") to certify that[28] *(a)* they have reviewed the periodic reports and that, based on their knowledge, such reports do not contain any untrue or misleading information and fairly present in all material respects the financial condition and results of operations of the issuer; *(b)* they have designed, established and maintained such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities; and *(c)* they have disclosed to the issuer's auditors and the audit committee of the board of directors all significant deficiencies in the design or operation of internal controls as well as any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.

Furthermore, the SEC was empowered to *(a)* remove officers and directors from their positions, and to bar them from occupying similar offices at other public companies by simply demonstrating their "unfitness,"[29] and *(b)* to obtain in the federal courts "any equitable relief that may be appropriate or necessary for the benefit of investors."[30]

The fourth major reform was the enhancement of financial disclosures, requiring among other measures[31] "reporting" companies to make more current

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[23] See sec. 201 (a) of the SOX.

[24] Id.at secs. 201 (a) and 202.

[25] Id. at sec. 203.

[26] Id. at sec. 204.

[27] See id. at sec. 301. This section mandates that the audit committee shall be directly responsible for the appointment, compensation, and oversight of the work of any accounting firm employed by the issuer. This section further restates that the audit committee shall have the authority to engage independent counsel and other advisers.

[28] See id. at sec. 302. This section should be read together with Section 906 that sets forth greatly enhanced criminal sanctions for certifications that are knowingly false.

[29] The previous standard required the court to find "substantial unfitness."

[30] See sec. 305 of the SOX. Under the same title the SOX forbids insider trading during pension fund blackout periods (sec. 306) .and sets the rules of professional conduct for attorneys appearing and practicing before the SEC (sec. 307).

[31] Including measures such as (a) forbidding direct or indirect personal loans to any director or executive officer, (b) requiring that principal stockholders, officers, and directors report to the SEC all changes in ownership of securities within two business days of the transaction (instead of the following month as formerly required), (c) requiring an internal control report that must be included in the "reporting" companies' annual report and "state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting", (d) requiring each issuer to disclose whether or not, and if not, the reason therefore, such issuer has adopted a code of ethics for senior financial officers, the audit committee is comprised of at least one financial expert, and finally (e)

disclosure of material changes in their financial condition[32] and to disclose all material off-balance sheet transactions, arrangements, obligations and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on the financial condition of the company.[33]

The fifth significant reform was the promotion of rules to face the conflicts of interests of securities analysts, instructing the SEC to promulgate rules that govern their independence and objectivity and protecting them against retaliation by their firms because of negative research or ratings.[34]

The sixth major reform was the tightening of corporate and criminal fraud accountability. Among the adopted rules, I highlight *(a)* the extension of the statute of limitations for securities fraud suits,[35] *(b)* the increase of the criminal penalties for altering or destroying documents[36] and for securities fraud,[37] and *(c)* the protection of whistleblowers by instructing publicly traded companies not to "discharge, demote, suspend, threaten, harass or in any other manner discriminate" against an employee who provides information to, or otherwise assists, a Federal regulatory or law enforcement agency, any Member of Congress or a person with supervisory authority over the employee about conduct that the employee "reasonably believes" to constitute a violation of the securities laws or the federal laws prohibiting fraud against shareholders.[38]

IV. WHAT ABOUT EUROPE?

A. General Overview of the Ongoing European Reforms

The creation of a European legal framework for auditors was integrated into the effort to harmonize company law, which has long been a goal of the European Union, and to create a single capital market, as outlined in the Financial Services Action Plan[39] and endorsed by the Stockholm European Council.[40]

The harmonization started with the requirement that the annual and consolidated accounts of certain companies had to be audited by a qualified professional (Fourth Council Directive 78/660/EEC, of 25 July 1978, on the annual accounts of certain types of companies.)[41] The step that followed was the definition of the minimum

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requiring the SEC to review "reporting" issuers' disclosures on a regular and systematic basis ("in no event shall an issuer required to file reports under section 13(a) or 15(d) of the Securities and Exchange SOX of 1934 be reviewed under this section less frequently than once every three years").

[32] See sec. 409 of the SOX, which requires "reporting" companies to disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English.

[33] See id. at sec. 401.

[34] See id. at sec. 501.

[35] See id. at sec. 804.

[36] See id. at sec. 802.

[37] See id at sec. 807.

[38] See id. at sec. 806. Other criminal provisions are scattered randomly over three separate titles.

[39] COM (1999) 232, 11.5.1999.

[40] Presidency Conclusions, Stockholm European Council, March 23 and 24, 2001.

[41] The Seventh Council Directive (83/349/EEC) of 13 June 1983 on consolidated accounts has extended the audit requirement to all entities which draw up consolidated accounts on the basis of the Directive. Similarly, the Council Directives 86/635/EEC, of 18 December, on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC, of 19 December 1991, on the annual accounts and consolidated accounts of insurance undertakings have introduced a requirement

qualifications of the statutory auditor (Eighth Council Directive 84/253/EEC, of 10 April 1984, on the approval of persons responsible for carrying out the statutory audits of accounting documents).

This regulation however did not provide any guidance as to auditors' independence, appointment, dismissal, fees, reports, or liability. These issues were dealt with in the proposed Fifth Directive on the structure of public limited companies and the powers and obligations of their organs, which was abandoned in 1991. They have been either regulated at the national level or subject to self-regulation, meaning that there are significant differences in the adopted solutions or that in some instances there is simply an absence of legislative backing.

This situation is not compatible with the needs of a single European market as the Commission recognizes, thus promoting several studies - such as the study on "Competition in European accounting" (1992) and on the "Role, the position and the liability of the statutory auditor" (1996) – which did show that there was no European market in audit services and that important differences remained between the national laws and regulations of Member States.

The Commission further promoted a wide-ranging review of the need and scope for further action at European level on the statutory audit. As a first step, the Commission published a Green Paper on the "Role, the position and the liability of the statutory auditor within the EU"[42] followed by a Conference to discuss these issues.[43] The Green Paper was supported both by the Economic and Social Committee (in the opinion adopted on February 26, 1997), which urged the Commission to establish priorities and an action plan setting forth minimum requirements for the European Union, and by the European Parliament (in the resolution adopted on January 15, 1998), which recommended the adoption of auditor independence requirements and new legislation on this issue.

Based on the results of the studies promoted and the comments received, and following the recommendation of the Economic and Social Committee, on May 8, 1998 the Commission issued the Communication on "The statutory audit in the European Union: the way forward."[44] This Communication set out an action plan based on the following main proposals:

(i) Creation of the Committee on Auditing, composed of representatives of the audit profession, to review the international standards on auditing and their application in an EU context (contributing to the work of the International Auditing Practices Committee of the International Federation of Accountants) and to examine the audit quality monitoring systems in the Member States and suggest proposals for improvement; and finally to examine the principles on independence developed by the European accounting profession;

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for all entities covered by those Directives to have their annual accounts and consolidated accounts audited by a qualified professional.

42 "Green Paper on the role, the position and the liability of the statutory auditor within the European Union", European Commission, 1996. Available at the website of the European Commission, http://europa.eu.int/comm/internal_market/en/company/audit/docs/700996en.pdf [hereinafter "Green Paper"].

43 Conference on The Role, the Position and the Liability of the Statutory Auditor within the European Union, Brussels, December 5 and 6, 1996. See the corresponding Act available at the website of the European Commission, http://europa.eu.int/comm/internal_market/en/company/audit/docs/acten.pdf.

44 Commission Communication on the statutory audit in the European Union: the way forward, May 08, 1998, 1998 OJ C 143 [hereinafter "1998' Commission Communication"].

(ii) Review of the international standards on auditing (ISA) in an EU context;
(iii) Promotion of quality control for compliance with standards and the independence principle;
(iv) Promotion of the role of auditors in Corporate Governance, requiring the creation of audit committees and the institutionalization of the internal audit function;
(v) Analysis of the need and feasibility of harmonizing the rules on professional liability of the statutory auditor.

After the failure of the proposed fifth directive, the Commission finally managed to put these issues back on the agenda and, following this Communication, the Commission issued two Recommendations.

First, the Commission Recommendation 2001/256/EC, of November 15, 2000, on quality assurance for the statutory audit in the European Union: minimum requirements. The Commission thereby aimed at setting a benchmark for Member State quality assurance systems, recommending common minimum requirements, for example:

(i) All auditors should be subject to quality assurance systems;
(ii) Both peer review and monitoring (i.e. situation where staff employed by the professional body or regulator manages the quality assurance system and carries out the quality assurance review) are accepted methodologies for quality assurance;
(iii) The selection of auditors for review should be made on a consistent basis so as to ensure coverage of all auditors over a maximum period of six years (this period should be shortened both for auditors with "public interest entity"[45] clients and for auditors previously reviewed with less than satisfactory results);
(iv) The scope of the quality review should include an assessment of the internal quality control system of the audit firm;
(v) Quality assurance systems should have adequate public oversight consisting of a majority of non-practitioners on the overview board of the quality assurance system and should provide for the publication of quality assurance results;
(vi) An adequate disciplinary system should be put in place and should include the possibility of removal of the auditor from the audit register;
(vii) Auditors should be exempted from confidentiality clauses regarding audit files of clients for purposes of quality assurance reviews and the reviewer should be subject to confidentiality rules similar to those that auditors have to comply with; and
(viii) The quality assurance system should also ensure the quality, independence and objectivity of the reviewer.

The second Recommendation was the Commission Recommendation 2002/590/EC, of May 16, 2002, on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles. In this Recommendation, the Commission thereby promoted a common understanding of the independence requirement, recommending the application of common fundamental principles and independence standards (always reaffirming a principles-based approach to the problem). In addition, the

[45] The term "public interest entity" includes amongst others: listed companies, credit institutions, insurance companies, investment firms, UCITS (undertakings for collective investments in transferable securities) and pension funds.

Commission reaffirmed its understanding that the audit profession has the primary responsibility to uphold auditor independence.

In fact, the Commission presented the following outline: "When carrying out a Statutory Audit, a Statutory Auditor must be independent from his Audit Client, both in mind and in appearance. A statutory auditor should not carry out a Statutory Audit if there are any financial, business, employment or other relationships between the statutory auditor and his client (including certain non-audit services provided to the audit client) that a reasonable and informed third party would conclude compromise the statutory auditors independence."

In light of this, the fundamental principles recommended were:

> (i) Auditors must be and look like objective and independent;[46]
> (ii) It is the responsibility of the auditor to ensure that the independence requirement is complied with;
> (iii) Risk assessment of auditor's independence should consider different types of threats – including self-interest, self-review, advocacy, familiarity or trust, and intimidation – and have due regard to the services provided to and the relationship with the audit client, before and during the course of the audit. The Commission Recommendation specifically states that business relationships between the auditor and its client may endanger its independence and should therefore be prohibited unless "they are in the normal course of business and insignificant in terms of the threat they pose to the independence of the Statutory Auditor". Furthermore, the Recommendation indicates a number of instances where the provision of certain non-audit services to the audit client (such as general outsourcing of internal audit or the design and implementation of financial information technology systems) should be prohibited because these services are perceived as causing an unacceptable high level of risk to the independence of auditors. Finally, the Recommendation suggests a rotation of the key audit partners within seven years of appointment to the engagement team as well as the introduction of a cooling-off period of two years for partners of audit firms joining their client;
> (iv) Different types of safeguards — including prohibitions, restrictions, other policies and procedures, and disclosures — have to be established in order to mitigate or eliminate threats to statutory auditors' independence. The auditor should specifically consider whether the governance structure of the audit entity provides safeguards to mitigate threats to his independence. Such safeguards should include the appointment by persons other than the audited entity's management and oversight and communications within the audited entity regarding the audit and other services provided by the auditor. Furthermore, audit firms should be controlled by persons who are authorized statutory auditors within the European Union and have adequate internal safeguarding systems; and
> (v) Auditors should disclose all fees received from their clients regarding both audit and non-audit services provided during the client's reporting period.

The regulation of auditing services was developing at its usual slow pace (although within the construction of a single capital market as defined in the Financial Services Action Plan and no longer as part of the slower process of

[46] Principles and rules on statutory auditors' independence should allow a reasonable and informed third party to evaluate the procedures and actions taken by a Statutory Auditor to avoid or resolve facts and circumstances that pose threats or risks to his objectivity.

harmonization of corporation law) when the financial scandals started arising in the United States.

Following the US uproar, the Commission prepared a note for the informal ECOFIN council that took place in Oviedo on April 12 and 13, 2002, containing "A first EU response to Enron related issues."[47] In light of the recent financial scandals, this note contains a brief analysis of such issues as financial reporting, statutory audit, corporate governance and transparency in the international financial system and financial analysts' research and the role of rating agencies.

In relation to the statutory audit, the Commission highlighted the fact that the Enron case had revealed deficiencies and weaknesses in US auditing and had led to criticism notably of audit firm to audit firm peer review (external quality assurance), the ineffectiveness of the public oversight body funded by the audit profession, the malfunctioning of audit committees, and the lack of independence of the auditor.

The Commission's reaction to the US scandals was then limited to this analysis and to the review of the Recommendation on Auditor Independence that was to be published a couple of months thereafter. However, as the scandals started to emerge in Europe there was mounting pressure for a response. The Commission reacted by issuing, on May 21, 2003, the Communication on "Reinforcing Statutory Audit in the European Union"[48] as part of its initiative to enhance corporate governance.

In this communication, the Commission recognized that the plan set out in the Communication on "The Statutory Audit in the European Union, the way forward" was depleted, and that the situation created by the successive financial scandals required further initiatives to reinforce investor confidence in the capital markets and to enhance public trust in the audit function in the European Union.

The first initiative presented in the Communication was the modernization of the Eighth Directive. Considering the new scenario, the Commission determined that non-binding instruments – such as the aforementioned Recommendations issued in 2000 and 2005 – should not be solely relied upon to deliver the necessary degree of rigorous application. The Commission therefore proposed a modernization of the Eighth Directive to provide a comprehensive legal basis for all audits conducted within the European Union. As referred to above, this Directive, approved in 1984, lacked comprehensive regulation of such important issues as public oversight, disciplinary systems and ethical codes.

The second initiative presented was the creation of an Audit Regulatory Committee. Consistent with the policy of "monitored self regulation," in 1998 the Commission created a Committee on Audit – composed of representatives from the audit profession[49] – to be a preparatory discussion forum between regulators and the audit profession. However, the new circumstances required a balance between representatives of the public interest and those of the audit profession in order to ensure the independence of EU policy making. The balance proposed consisted of renaming the Committee on Audit to Audit Advisory Committee – which would keep the same function - and creating the Audit Regulatory Committee.

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[47] Available at the website of the European Commission, http://europa.eu.int/comm/internal_market/en/company/company/news/ecofin_2004_04_enron_en.pdf. Published shortly before the above referred Recommendation on auditors Independence.

[48] Commission Communication on Reinforcing Statutory Audit in the European Union, May 21, 2003 , 2003 OJ C 236 [hereinafter "2003' Commission Communication"].

[49] For more details, see 1998' Commission Communication above.

The third initiative proposed was the reinforcement of the audit function, including the adoption of such measures as *(a)* the use of ISAs for all audits from 2005; *(b)* the harmonization and enhancement of public oversight of the audit profession; *(c)* the improvement of auditor independence from executive directors by developing principles on their appointment, dismissal and remuneration; *(d)* the requirement of independent audit committees and involvement of auditors in the assessment and reporting on internal control systems; *(e)* the issuance of a harmonized code of ethics; *(f)* monitoring the implementation of the Commission Recommendation on Statutory Auditors' Independence in the EU and incorporation of its basic principles in the modernized Eighth Directive; *(g)* monitoring the implementation of the Commission Recommendation on Quality Assurance for the Statutory Auditor in the EU and incorporation of a requirement for quality assurance systems in the modernized Eighth Directive; *(h)* requiring auditors to have specific education and training; *(i)* Requiring an adequate and effective disciplinary sanctioning system; and *(j)* Implementing a minimum level of transparency of audit firms and their networks.

Finally, the fourth initiative was the reinforcement of the internal market for audit services, by removing all unnecessary restrictions that could frustrate intra-management and ownership of audit firms, and promoting mutual recognition of professional qualifications to allow cross-border provision of audit services.

Following the objectives set forth in the 2003 Communication referred to above,[50] the Commission presented a Proposal for a Directive on statutory audit of annual accounts and consolidated accounts, on March 15, 2004.[51] The proposed Directive will modernize the Eighth Directive and introduce slight amendments to the Fourth and Seventh Directives. Many of its provisions are already part of the recommendations on audit quality assurance and auditors independence. Considering the need to reinforce investors' confidence in the market and audit profession, those rules are now suggested to be included in a binding document that assures a stricter harmonization and implementation policy.

The main provisions of the proposed Directive include the following:

- First, that all auditors be registered in a public electronic register, which must be accessible electronically and which will provide transparency regarding the auditors and audit firms;
- Second, that auditors must be subject to a code of ethics;
- Third, auditors must be independent from their clients (prohibiting any involvement in management decisions and the provision of audit services if there is any financial, business, employment or other relationship – including the provision of additional services – that might compromise their independence). It should be highlighted that the Commission decided not to follow the US example (at least for now), avoiding a direct prohibition on offering non-audited services to audit clients. As regards the audit fees, the principle is maintained that they should not be based on any form of contingency or influenced by the provision of additional services to the audited entity.

[50] See supra note 48.

[51] Available at the website of the European Commission http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=52004PC0177&model=guichett.

- Fourth, in relation to the audit reporting, two important measures were adopted: (i) all audits within the European Union must be carried out in accordance with the international auditing standards adopted by the Commission and (ii) group auditors should bear full responsibility for the audit report in relation to consolidated accounts. The first was a long expected measure to harmonize auditing standards within the European Union, following a principles-based system. The second measure is a reaction to the Parmalat case.
- Fifth, in accordance with the corresponding Recommendation, all auditors will be subject to a system of quality assurance.[52]
- Sixth, Member States must organize effective systems of investigation and effective and dissuasive sanctions, which may be civil, administrative or criminal, as well as ensure appropriate disclosure to the public. Sanctions must include the withdrawal of approval of statutory auditors or audit firms.
- Seventh, public oversight is one of the most important topics due to the impact it has on the enhancement of confidence in the audit profession. Following the principle established in the Recommendation on quality assurance, the proposed Directive requires credible supervision by a clear majority of non-practitioners (for public interest entities, the oversight must be carried out exclusively by non-practitioners) with knowledge in accounting and auditing. The systems of public oversight must be coordinated at the European level. For that purpose it is established that Member States shall recognize each other's oversight in regulatory systems. Also, the rules for effective cooperation between Member States in investigations of audit firms are defined.
- Eighth, following the principle set forth by the Recommendation on auditor independence, the appointment of the auditor should be independent from those who prepare the financial statements of the audited entity. Thus, the auditor shall be appointed by the general meeting of shareholders.[53] With regard to the dismissal and resignation of auditors, the proposed Directive introduces the principle that the auditor can only be dismissed on proper grounds, which must be disclosed to the responsible oversight authorities. Finally, the effective communications between the auditor and its client shall be regulated by each Member State in accordance with its corporate governance structure. At minimum, they must ensure that those communications shall be recorded by the client in order to allow its independent directors an overview of the relationship with the auditor;
- Ninth, Additional requirements are set forth for the audit of public interest entities because they raise further concerns: (a) Quality review cycles are shortened to three years (instead of six); (b) Auditors of public interest entities must disclose a detailed report that gives an insight into the audit firm and its network; and (c) public interest entities must have an audit committee responsible for monitoring the financial reporting process; the effectiveness of the company's internal control, internal audit where applicable, and risk management systems; the statutory audit; and the independence of the auditor and in particular its provision of non-audit services. In addition, the audit committee shall select the auditor to be proposed for approval by the general meeting of shareholders. Finally, the auditor should communicate on a timely

52 See Commission Recommendation 2001/256/EC above.

53 In accordance with national law, Member States may provide that such appointment is subject to prior approval by a competent supervisory authority or that the appointment is made by a court or another organization designated by national law (See Art. 35).

> basis with the audit committee on those matters of governance interest[54] that arise from the audit of the financial statements.[55]

As of the final revision of this article (May 2005), the Committee on Legal Affairs of the European Parliament was preparing a report on this proposal of the Commission, suggesting some amendments.[56] Among such amendments I highlight, on one hand, the limitation of auditors' liability set forth by the new Article 30 A, and, on the other hand, the deletion of Article 39 that required public interest entities to have an audit committee responsible for monitoring the financial reporting process.[57]

B. Auditor Independence

Auditor independence is the most important issue under discussion following the latest financial scandals. The entire 'gatekeepers' theory (and practical application) depends upon the private incentives of an independent third party whose reputation is the most significant asset it has to pledge when verifying or certifying disclosed information. If that third party has more incentive to be lenient with its client than to defend its reputation as an independent expert, the whole system fails.

The US Congress' approach to this fact in the SOX is considered by some, especially in Europe, as an overreaction to the manifest lack of independence of all 'gatekeepers' in many of the known scandals.

I shall consider below the most relevant issues on auditor independence, comparing the measures adopted in the US and those under discussion in Europe.

1. Appointment, compensation and oversight of the auditor: the relevance of the audit committee

The requirement that listed companies – in the United States – or public interest companies – in Europe – have an efficient audit committee responsible for monitoring both the financial reporting process and the audit of the companies' accounts is one of the most important guarantees of auditors' independence. Particularly important is the responsibility of the audit committee over the appointment, (or, in the European case, the selection for appointment by the shareholders general meeting,[58]) compensation and oversight of the auditor. However, the agreement between US and EU institutions as to the Audit Committee

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[54] Such key matters may include information about the audit, significant changes in accounting policies, significant risks and exposures facing the company, material audit adjustments and uncertainties, disagreements with management, management, and material weaknesses in internal control in relation to the financial reporting process.

[55] One last feature of this proposed directive is the regulation of the international aspects of the European system. For more details, see Arts. 44 to 47.

[56] Draft Report, by Bert Doorn, PE 353.280v01 (19.01.2005) and PE 355.347v02-00 (08.04.2005).

[57] As mentioned above in the description of the main provisions of the Proposal for a Directive on Statutory Audit of Annual and Consolidated Accounts, para. 9.

[58] Please note that the Draft Report of the Committee on Legal Affairs, of the European Parliament, suggests the deletion of Article 39 from the Proposal for a Directive on statutory audit of annual accounts and consolidated accounts, which required public interest entities to have an audit committee responsible for, inter alia, the selection of the statutory auditor to be appointed by the general meeting of shareholders. It is not possible to determine at this moment whether this suggestion by Jean-Paul Gauzés in the Draft Report will be included in the final version of the Report and approved by the European Parliament.

is limited. There are significant differences in their approaches regarding its powers and the independence and financial expertise of its members. I consider below these issues from a comparative perspective as they deeply influence auditor independence.

a. Independence of the Audit Committee Members

In the United States, following stock exchange self-regulation,[59] as amended in accordance with the Recommendation of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999),[60] the SOX requires[61] that all members of the Audit Committee be independent. In Europe, the Winter Report II[62] and later the Commission Communication on Modernizing Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward,[63] suggested only that the majority of the audit Committee members be independent. This solution was defended by the High Level Group of Company Law Experts as more suited to the European situations relevant to board structures, like the existence of controlling shareholders and boards which are partly co-determined by employees.

The Directive recently proposed by the Commission includes a solution which is even softer than the one presented in the Winter Report II and in the above mentioned Communication. Pursuant to Art. 39,[64] Audit Committee members are not required to be independent (except for one of them who must also have competence in accounting and/or auditing). They are only required to be non-executive directors or members of the supervisory board.

Following Professor Guido Ferrarini,[65] I find the American approach more adequate. First, I think that controlling shareholders should not be represented in the Audit Committee. The independence of the Audit Committee from the influence of both management and controlling shareholders is essential to assure independent monitoring of managerial actions and the company's financial reporting process. Controlling shareholders are already represented at the board level, where they can perform their monitoring duties. They need not be represented at the audit committee level.

Second, the employees' argument is a more complex one, but the practice has already provided a good solution. In order to comply with the German system of

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[59] See e.g. the New York Stock Exchange, Listed Company Manual § 303.0l(B)(2)(a) provides: "Each audit committee shall consist of at least three directors, all of whom have no relationship to the company that may interfere with the exercise of their independence from management and the company".

[60] Available at the website of the NYSE, http://www.nyse.com/pdfs/blueribb.pdf.

[61] Under sec. 301 of the SOX, the SEC must adopt rules requiring stock exchanges to prohibit the listing of securities of those companies that do not comply with the requirement (among other) that all Audit Committee members be independent and cannot accept any consulting, advisory, or other compensatory fee from the issuer.

[62] See supra note 8.

[63] COM (2003) 284(01). Available at the website of the European Commission, http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0284en01.pdf.

[64] As referred above in note 58, the Draft Report of the Committee on Legal Affairs, of the European Parliament, suggests the deletion of Article 39 from the Proposal for a Directive on statutory audit of annual accounts and consolidated accounts.

[65] Guido Ferrarini, European Corporate Governance after the Sarbanes-Oxley Act, at 3 (on file with the author) [hereinafter "Ferrarini, European Corporate Governance"].

codetermination, companies should appoint workers that are not employees of the company, such as union representatives. This is the solution adopted by German companies listed in the United States, which must therefore comply with the provisions of the SOX referred to above.

b. Expertise of the audit committee members

Expertise of the Audit Committee members is another issue that differentiates the US and EU approaches. Once again following a widespread practice, the SOX requires[66] – on a "comply or explain" basis – that all members of the audit committee possess some financial expertise and that at least one of them be a "financial expert."[67] In Europe, the Winter Report II recommends that all board members have "basic financial understanding" and that their competence be explained annually against a profile of board composition. However, the report implicitly rejects the SOXs' requirement that at least one of the Audit Committee members be a financial expert.

The proposed Directive neither requires that the Audit Committee members have "basic financial understanding" nor that any member be a financial expert. It only requires that one of the members has "competence in accounting and/or audit".

This solution does not seem sufficient. If the Audit Committee is responsible for monitoring the financial reporting process as well as both the internal and statutory audits, it seems essential that all of its member have at least some level of financial understanding. Furthermore, and once again agreeing with Guido Ferrarini,[68] those same reasons seem to fully justify the requirement that at least one of the members be a financial expert. I believe that this solution is more efficient than relying on the services provided by an outside expert. In addition, the "comply or explain" solution is flexible enough to allow a company that prefers a different solution not to comply, as long as it explains its reasons.

c. Powers of the audit committee: appointment, compensation and oversight of auditors

Regarding the powers of the Audit Committee, the SOX sets out that "the audit committee … shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer … for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee."[69] [70] The Winter Report II suggests – and the proposed Directive

[66] Under sec. 407 of the Act, the SEC must adopt rules requiring quarterly and annual disclosure of whether at least one committee member is a financial expert and, if not, why not.

[67] The SEC was also instructed to define the term "financial expert", considering whether a person has the necessary expertise "through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance or similar functions.

[68] Ferrarini, European Corporate Governance, supra note 65, at 5.

[69] Pursuant to sec. 301(2) of the SOX, the SEC is instructed to require stock exchanges to prohibit the listing of securities of companies that do not comply with this rule.

[70] For more details, see para. **Error! Reference source not found.**(ii) above which includes a description of sec. 204 of the SOX.

includes – the adoption of similar powers concerning auditors' oversight, but there are substantial differences in relation to their appointment and compensation.

Unlike the SOX, the Winter Report II suggests – and the proposed Directive sets out – that the Audit Committee shall be responsible for the selection of the auditor to be appointed by the shareholders general meeting. Thus, the final decision on the appointment of the auditor lies in the shareholders general meeting (as is the rule in most Member States). Considering the objectives of the ongoing reform and the fact that the majority of European companies have concentrated ownership, it would have been better to follow the American model. The appointment of auditors by the shareholders general meeting allows the controlling shareholder of a company to have the final word on the issue. This solution is in clear contradiction with the purpose of the Audit Committee to ensure the independence of the auditors from the management and controlling shareholders.

In the United States, on the one hand, the adoption of the rule whereby auditors must be appointed by the Audit Committee (i) is compatible with state law, which confers the power to appoint the auditors to the Board of Directors, avoiding a conflict between federal and state law in a matter traditionally reserved to the latter; and (ii) allows the appointment of auditors free of management's influence (at least that is the objective, and it remains to be seen whether this can be accomplished). On the other hand, the adoption of the European model in the United States would make the appointment of auditors subject to managers' choice, as they generally control proxy contests.

In Europe, the adoption of the American model would be contrary to the current rules in the majority of the Member States, but harmonization through the implementation of new solutions is nothing strange in the European Union.

As for the compensation of auditors, the Winter Report II provides that the Audit Committee should be responsible for the determination of the conditions of the appointment of auditors. We may assume that such conditions include remuneration. However, the proposed directive left this item blank. Even considering that the Audit Committee will have the power to review and monitor the independence of the auditor and, therefore, its compensation, it would have been better to adopt a clear position, conferring the power to determine the conditions of appointment to the Audit Committee.[71]

2. Relationship between auditors and clients

Any kind of relationship between the Auditor and its client that goes beyond the provision of audit services may endanger the auditor's independence. The provision of non-audit services can be especially problematic but other kind of relationships also raise concerns.

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[71] Note that two other rules regarding compensation of auditors were included in the proposed Directive: (i) As referred in its Recital 26, "With a view to provide more transparency on the relationship between the statutory auditor or audit firm and the audited entity, Directives 78/660/EEC and 83/349/EEC should be amended so as to require the disclosure of the audit fee and the fee paid for non-audit services in the notes to the annual accounts and the consolidated accounts" (See Art. 50 of the proposed Directive). (ii) Pursuant to Art. 25, the audit fees must be adequate, not influenced by the provision of additional services to the audited client and not based on any form of contingency.

The proposed Directive, once again adopting a principles-based solution, provides that auditors may not be involved in the management decisions of their clients and "shall not carry out a statutory audit if there is any financial, business, employment or other relationship, including the provision of additional services, with the audited entity that might compromise the statutory auditor's or audit firm's independence."[72] We shall see in the future whether the European principles-based system works better than the American rules-based system.

One important rule that was established both by the SOX and by the proposed Directive is the requirement of a "cooling-off" period before a member of the audit firm may take up a key management position with an audit client.[73] However, the rules are slightly different in the US and in the EU as to their time extension, persons affected and, in particular, the content of the prohibition.

The US adopted a "cooling-off" period of one year applicable to any "person employed by [the] registered public accounting firm [that] participated in any capacity in the audit of that issuer." As to the content of the prohibition, it is unlawful for the audit firm to perform any audit service if any person serving in a key management position of the client was employed by the audit firm and participated in the audit of that client in the previous year.

The EU adopted a two year "cooling-off" period applicable only to "the statutory auditor or key audit partner who carries out the statutory audit on behalf of the audit firm." As to the content of the prohibition, it has broader implications because it directly prohibits the key audit partner from taking up a key management position during the "cooling-off" period, instead of just prohibiting the audit firm to perform audits during that period.[74]

These differences may be of importance as the assumption of a key management position in a company by its former auditor may carry two kind of risks. On the one hand, the auditor may be persuaded by the promise of a key management position to acquiesce to its client's fraud. On the other hand, a former auditor who assumed a key management position in a client may be in a good position to influence its former firm to acquiesce to future frauds.

Considering these two risks, I believe that the European solution is more adequate not only in relation to the affected persons but also the content of the prohibition. In relation to the affected persons, (i) the key audit partner is the most responsible for the audit and therefore he is the one who must be persuaded not to acquiesce in exchange for a future key management position in the audit client; and (ii) only an ex partner could put sufficient pressure on the audit firm to acquiesce in future frauds of the client. Regarding the content of the prohibition, while the European solution seems to address both risks described above, the US solution seems to deal with only the second risk, not allowing the audit firm to perform any audit during the set "cooling-off" period.

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[72] See Art. 23 of the Proposal for a Directive.

[73] See id. at Art. 40.

[74] It should be highlighted that the Draft Report of the Commission on Legal Affairs, of the European Parliament, supra note 56, includes several proposals of amendment to Article 40 of the Proposal for a Directive. One of those proposals, by Antonio Masip Hidalgo, includes the deletion of this "cooling-off" provision. See pages 36 and 37 of the Draft Report.

3. Auditor rotation

Auditor rotation may increase independence in two different ways: (i) it reduces auditors' complicity arising out of a continuous relationship and (ii) it introduces a deterrent effect as the work performed by any auditor would be reviewed by another in future.

In order to ensure the independence of the evaluations and judgments made by an auditor it is fundamental that he maintains his objectivity when analyzing his clients' transactions and records. The continuous relationship between the auditor and its client creates professional and sometimes personal ties that develop an increasing complicity.[75] The periodical rotation of auditors reduces this risk, allowing reviews to be more objective. Auditor rotation is also a deterrent because auditors know that their work will probably be reviewed by other auditors. As for the client, it is harder to convince more than one auditor to acquiesce with a fraud, especially when such acquiescence may be detected in a future audit by a different auditor.

There may be two types of auditor rotation: audit firm or audit partner rotation. These two types may be alternative or complementary.

In the United States, Congress imposed a five years audit partner rotation system (Section 203 of the SOX) and requested the Comptroller General of the United States to conduct a study and review of the potential effects of requiring mandatory rotation of audit firms (Section 207 of the SOX).

In Europe, the Commission Recommendation on Auditor Independence included a provision suggesting an audit partner rotation every seven years, but the proposed Directive went further, providing for a more flexible solution. Pursuant to Article 40 (c), the statutory auditor or the key audit partner responsible for carrying out the statutory audit on behalf of the audit firm shall rotate from the statutory audit engagement within a maximum period of five years or, alternatively, the audit firm shall rotate within a maximum period or seven years[76].

The rotation of audit partners may not be as effective as the rotation of audit firms (as it is not clear whether a partner of an audit firm would blow the whistle in the face of a fraud committed by another partner of the same firm), but it is less costly as the new audit partner may use the resources developed by the audit firm for that client. The rotation of audit firms increases significantly the cost of services rendered by auditors who will have to get to know the client and start their work from scratch. This increase in cost will be reflected in the prices of the services. The

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[75] See Green Paper, supra note 42, para. 4.15, where it is stated that "Some commentators find cause for concern where a company retains the same auditors for a long period. It is argued that this can lead to too close and cozy a relationship with management, with the auditors becoming too responsive to management's wishes."

[76] It should be highlighted that the Draft Report of the Commission on Legal Affairs, of the European Parliament (see supra note 56) includes several proposals of amendment to Article 40 of the Proposal for a Directive. Some of those proposals exclude the alternative of audit firms rotation, alleging that such provision would "damage the quality of the audit because it means that there is less knowledge of the firm concerned and of its risks, control procedures and other important aspects". Some other proposals maintain the alternatives of audit partner and audit firm rotation, but extend the rotation period of audit partners from five to seven years. Those same proposals suggest that audit partners and audit firms shall be allowed to participate in the audit of their former client after a minimum period of two years after the rotation.

question now is whether shareholders are better off with or without this system. I believe that the audit firm rotation system will decrease shareholder value in the short term but it will increase it in the long run.

4. Non-audit services

a. Should auditors be barred from providing non-audit services?

This is probably one of the most widely discussed issues in the reform of auditors' legal regime in the United States and in Europe. One of the major causes of the frauds in the United States was that auditors' benefits gained by collaborating with their clients rose in the 1990's as the Big Five audit firms realized that they could profit much more by cross-selling their consulting services. Indeed many saw the auditing function primarily as a tool to bait lucrative clients.[77] From the beginning of the 1990's until the enactment of the SOX there was an increasing tendency for companies to pay their auditors much more for consulting services than for audit services.[78]

This fact created two problems. First, it provided auditors with an enormous incentive to please their audit clients and, second, it allowed clients to put pressure on their auditors by threatening to dismiss their consulting services. The first problem affected not only the audit firm as a whole but especially the key audit partner, because his remuneration depended on the cross-selling of non-audit services and because he was subject to pressure from other partners to do so.

As for the second problem, it is linked to the difficulty of firing an auditor in the real world. When a corporation wants to fire its auditor it must publicly disclose the reasons for doing so, which would probably subject the company to both regulatory supervision and public embarrassment.[79] If the audit company combines the

[77] See Kam Wah Lai and Andrew Yim, Non-Audit Services and Big 5 Auditor Independence: Evidence from Audit Pricing and Audit Opinion of Initial Engagement. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=340000#PaperDownload. In this paper the authors examine audit pricing and audit opinion of initial engagement when the audit firms also provide non-audit services. Using U.S. data, they report that when Big 5 audit firms provided more non-audit services to their new clients, they were more likely to charge less audit fees.

[78] The provision of consulting services to audit clients was not material prior to the 90's but the increase in the mid 90's was astonishing. See SEC Release No. 33-7919 on "Final Rule: Revision of the Commission's Auditor Independence Requirements". See also John C. Coffee, Jr., Understanding Enron: It's About the Gatekeepers, Stupid, Columbia Law and Economics Working Paper No. 207, at 14. Available at http://ssrn.com/abstract_id=325240 [hereinafter "Coffee, It's About the Gatekeepers"]. According to John Coffee, a large public corporation usually paid its auditor three times more for consulting services than for auditing services. See Coffee, It's About the Gatekeepers, at 14. A survey (of 2002) by the Chicago Tribune finds that the one hundred largest corporations in the Chicago area (determined on the basis of market capitalization) paid on average consulting fees to their auditors that were over three times the audit fee paid to the same auditor. See Janet Kidd Stewart and Andrew Countryman, "Local Audit Conflicts Add Up: Consulting Deals, Hiring Practices In Question," Chicago Tribune, February 24, 2002 at C-1. The extreme example in this study was Motorola, which had over a 16:1 ratio between consulting fees and audit fees.

[79] In the United States, Item 4 ("Changes in Registrants Certifying Accountant") of Form 8-K requires a "reporting" company to file a Form 8-K within five days after the resignation or dismissal of the issuer's independent accountant or that of the independent accountant for a significant subsidiary of the issuer. The Form 8-K must then provide the elaborate disclosures mandated by item 304 of Regulation S-K relating to any dispute or disagreement between the auditor and the accountant. See 17 CFR 228.304 ("Changes in and Disagreements With Accountants on Accounting and Financial Disclosure").

provision of both audit and consulting services, it is opening the door for potential silent pressure by an audit client. This is however a theoretical problem not based on actual case histories, but, as John Coffee suggests, the fact is that it fits the available data. A study by academic accounting experts, based on proxy statements filed during the first half of 2001, finds that those firms that purchased more non-audit services from their auditor (as a percentage of the total fee paid to the audit firm) were more likely to fit the profile of a firm engaging in earnings management.[80]

However, the will to please the client and its pressure[81] are not the only problems arising out of a situation where auditors provide both audit and non-audit services. The risk of self review is itself another major problem that must be faced.

These risks were felt both in the United States and in Europe before, but it was the outbreak of the financial crisis that finally drew the world's attention to their potential consequences.[82] The reactions were different on either side of the Atlantic, as the pressure on Congress in the United States led it to adopt harsher measures. While the American solution was to directly prohibit audit firms from providing certain listed non-audit services, the European solution was once again a principles-based one.

Section 201 of the SOX prohibits accounting firms from providing nine types of non-audit services:

> (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment audit; and (9) any other service that the Board determines, by regulation, is impermissible.

This list reflects a compromise as the provision of tax services by audit firms, one of their major sources of income, was not prohibited. Auditors are allowed to provide other non-audit services as long as they are approved by the Audit Committee of the issuer, which must also approve all audit services provided to that issuer.

In Europe, so far the Commission decided not to adopt such a harsh position, but in its Recommendation on Auditor Independence it did establish some fundamental principles and guidelines which constitute its core policy on this matter, and the Commission did enumerate a number of non-audit services which should be

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[80] John Coffee cites a study of Richard Frankel, Marilyn Johnson, and Karen Nelson, The Relation Between Auditors' Fees for Non-Audit Services and Earnings Quality. MIT Sloan Working Paper No. 4330-02. Available from Social Sciences Research Network at www.ssrn.com at id= 296557. Firms purchasing more non-audit services were found more likely to just meet or beat analysts' forecasts, which is the standard profile of the firm playing "the numbers game". See Coffee, It's About the Gatekeepers, supra note 77, at 16.

[81] These risks were respectively identified by the Commission as "self interest threat" and "intimidation threat". See Commission Recommendation 2002/590/EC, of May 16, 2002, on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles, at paragraph 3 of the Annex.

[82] There are authors that do not agree with the conclusion that non-audit services impair auditor independence. See e.g. Mark L. Defond, Kannan Raghunandan, and K.R. Subramanyam, Do Non-audit Service Fees Impair Auditor Independence? Evidence from Going-concern Audit Opinions. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=297747); and Hollis Ashbaugh, Ryan Z. Lafond, and Brian Mayhew, Do Non-Audit Services Compromise Auditor Independence? Further Evidence. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=305720.

forbidden if certain conditions are not met.[83] The Commission began by identifying those situations which should be avoided due to excessive independence risks and then set out the conditions under which those situations should be prohibited.

The fundamental principle established by the Commission Recommendation was that auditors must be independent both in mind and in appearance. Thus, they should not carry out any audit if they have any relationship with the client that a reasonable and informed third party would conclude compromises the auditor's independence. The Recommendation further stated that when an auditor provides non-audit services to a client it must put in place a system of safeguards to ensure (i) that its employees who provide services to that client do not take part in any of its decision making processes and (ii) that it reduces any potential independence risk to an acceptable level.[84]

As for the enumerated risky situations that should be addressed or prohibited if certain conditions are not met, the Commission listed the following: (1) preparing accounting records and financial statements; (2) design and implementation of financial information technology systems; (3) valuation services; (4) participation in the audit client's internal audit; (5) acting for the audit client in the resolution of litigation; and (6) recruiting senior management.

Two things should be noted. First, the Commission adopted this position on the flexible prohibition of certain non-audit services in a non-binding instrument and decided not to include it in the proposed Directive, which only reaffirms the general principle that an auditor must be independent from the audited entity and must refuse any non-audit engagement which might compromise his independence as an auditor.[85] Second, even though the Recommendation's listing is very similar to the one contained in Section 201 of the SOX, some of the most important non-audit services were not included: broker or dealer, investment adviser, or investment audit.

In the Explanatory Memorandum accompanying the proposed Directive, the Commission referred to its intention to organize a study in order to examine whether further measures prohibiting auditors from offering non-audit services to their audit clients are necessary.

Meanwhile, the prohibitions established in the Recommendation on Auditor Independence are in force (although this is a non-binding instrument). As for the provision of broker, dealer, investment adviser, or investment audit services,

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[83] The Commission had already announced, in its "First EU response to Enron related policy issues" (Note for the Informal ECOFIN Council that took place in Oviedo in April 12 and 13, 2002), that the Recommendation would include "a number of instances where the provision of certain non-audit services to the audit client (such as a general outsourcing of internal audit or the design and implementation of financial information technology systems) [would be] prohibited because these services are perceived as causing an unacceptably high level of risk to an auditor's independence."

[84] The Commission Recommendation further suggests several safeguards that may mitigate a remaining independence threat: "(a) arrangements to reduce the risk of self-review by compartmentalizing responsibilities and knowledge in specific non-audit engagements; routine notification of any audit and non-audit engagement to those in the audit firm or network, who are responsible for safeguarding independence, including oversight of ongoing activities; (c) secondary reviews of the statutory audit by an audit partner who is not involved in the provision of any services to the audit client or to one of its affiliates; or (d) external review by another statutory auditor or advice by the professional regulatory body."

[85] See Art. 23 of the Proposal for a Directive. Please note that the Draft Report of the Commission on Legal Affairs, of the European Parliament (see supra note 56) includes several proposals of amendment to Art. 23.

although they are not directly forbidden, they are not permitted when endangering auditors' independence. According to the general principle established by the Recommendation and confirmed by the proposed Directive, it will be up to the auditor to prove that the provision of a given non-audit service did not endanger its independence, both in mind and in appearance. The merits of this principles-based solution remain to be proven, but it may work better that the extreme solution adopted by the SOX, as a positive balance has been achieved, at least theoretically.[86] On one hand it switches the burden of proof from the plaintiff to the defendant auditor, putting pressure on auditors to create adequate internal mechanisms to ensure that their independence is not affected. On the other hand, it allows a more efficient provision of services by auditors who will be able to make use of the knowledge and information gathered with the provision of non-audit services whenever such action does not affect their independence (both in mind and appearance).

In conclusion, the cautious position assumed by the Commission, grounded on a principle-based system, seems to be a more adequate response to the fragility of auditor independence – caused by the provision of non-audit services – although it does not reinforce investor confidence in the audit profession as the SOX does.

b. The problem of contingency fees and contingent remuneration of audit partners

As referred to above, the cross-selling of non-audit services by auditors generated two problematic situations. First, audit firms decrease the price of their audit services to make it easy to attract certain clients to whom they could then sell highly profitable non-audit services. Second, audit partners' remuneration was made dependent on such cross-selling results.

These problems were already faced in the United States even before the enactment of the SOX. Rule 2-01(b) [87] sets out that "the [SEC] will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement." Furthermore, subsection (c)(5) of the same rule deems the accountant not to be independent if he "receives a contingent fee or commission from an audit client." Based on these rules, John Coffee argued in 2001 that the link of an audit partner's compensation to the cross-selling of non-audit services was a form of contingency fee that not only qualified the partner itself as not independent but also the firm that

[86] In this direction see the arguments presented by Benito Arruñada, who stated that "The provision of non-audit services by auditors to their audit clients reduces total costs, increases technical competence and motivates more intense competition. Furthermore, these services do not necessarily damage auditor independence nor the quality of non-audit services. This assessment leads to recommending that legislative policy should aim at facilitating the development and use of the safeguards provided by the free action of market forces. Regulation should thus aim to enable the parties—audit firms, self-regulatory bodies and audit clients—to discover through competitive market interaction both the most efficient mix of services and the corresponding quality safeguards, adjusting for the costs and benefits of each possibility." See Benito Arruñada, The Provision of Non-Audit Services by Auditors: Let the Market Evolve and Decide, UPF Economics and Business Working Paper No. 423. Available at http://ssrn.com/abstract=224744.

[87] Of Regulation S-X. See 17C.F.R.§210.2-01(b).

he worked for. According to John Coffee, this conclusion may be reached by applying the objective appearance test – i.e. would a "reasonable investor with knowledge of all relevant facts and circumstances … conclude that the accountant is not capable of exercising objective and impartial judgment"? – outlined by Rule 2-01.

This problem lost some relevance with the enactment of the SOX which prohibited auditors from providing most non-audit services to their audit clients. However, the SEC decided to definitively address this issue by adding Rule 2-01(c)(8), which sets forth that "an accountant is not independent of an audit client if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on the audit partner procuring engagements with that audit client to provide any products or services other than audit, review or attest services."[88]

In Europe the problem was not solved. Even though both the Commission Recommendation on Auditor Independence and the proposed Directive contain provisions requiring audit fees to be adequate, and not influenced by the provision of additional services or based on any form of contingency – solving the first problem identified above - there is no specific provision regarding audit partners' compensation. Notwithstanding this, there is a general provision in the Commission Recommendation on Auditor Independence – Section 1 on "Objectivity, integrity and independence" of auditors – that might be applicable in the same terms as those defined by John Coffee for Rule 2-01(b).

The relevant part of this provision states that "the main way in which the Statutory Auditor can demonstrate to the public that a Statutory Audit is performed in accordance with [the] principles [of objectivity and professional integrity] is by acting, and being seen to act, independently." The comment contained in paragraph A.1 of the Annex explains that the requirement that a Statutory Auditor should be independent addresses both the independence of mind – i.e. the state of mind which addresses all considerations relevant to the task at hand, but no others – and independence in appearance – i.e. the avoidance of facts and circumstances which are so significant that a reasonable and informed third party would question the Statutory Auditor's ability to act objectively.

Applying John Coffee's construction, no reasonable and informed third party would believe in the independence of an audit firm whose partners' remuneration is set on a contingency basis as referred to above.

Although the EU solution is a viable one, it seems that the Commission could have addressed this issue directly in the Recommendation on Auditor Independence or in the proposed Directive.

C. Auditors Liability

1. Introduction

I consider this issue together with auditor independence as I believe these are the most relevant issues in the reform of the European legal regime applicable to the statutory auditor as a 'gatekeeper'. As I have set out to provide a general overview

[88] See SEC Release No. 33-8183, of January 28, 2003.

over the most important topics relating to these issues, their discussion is necessarily brief, notwithstanding my awareness that, in the words of Werner Ebke,[89] "the issue of the statutory auditor's liability to both his or her client and third parties is an extremely complex one. The tremendous differences that exist within the EU in this area of the law result not only from different legal traditions but also from different risk allocation and loss distribution techniques and corporate governance structures."

2. The need for gatekeeper liability and its evolution in the United States and in the European Union

As discussed above, 'gatekeepers' such as auditors are reputational intermediaries who pledge their reputation when they verify or certify information disclosed to the market. Reputation is auditors' most valuable asset that they must preserve at all costs under penalty of losing the necessary market credibility to provide auditing services. This is the first premise of any 'gatekeeper' theory. The problem is that practice has shown us that reputation is not incentive enough. The 1990's proved that under certain circumstances, the incentives for auditors to be lenient with their clients outweigh the value of their reputation, or that the latter is not a sufficient incentive to make these intermediaries comply with their incumbencies. For example, (i) auditors' failure may not result in the necessary reputational loss, possibly because in a very concentrated market such as the market for auditing services, it is likely that all major firms will be involved in some kind of scandal and thus investors may not differentiate meaningfully between them; (ii) the inducements offered to auditors may increase their willingness to take the risk; (iii) the value of reputational capital may decline, possibly because investors care less about gatekeeping services in a "bubble market"; and (iv) agency problems may arise within the auditing firms, as audit partners may be more willing to cooperate with the client than to preserve the firm's reputational capital.[90]

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[89] Werner F. Ebke, The Statutory Auditor's Professional Liability, in Act of the Conference on The Role, the Position and the Liability of the Statutory Auditor within the European Union, December 5 and 6, 1996, at 195. Available at http://europa.eu.int/comm/internal_market/auditing/docs/other/act_en.pdf [hereinafter Ebke, The Statutory Auditor's Professional Liability].

[90] For more details see Coffee, Gatekeeper Failure, supra note 17, at 13. Considering these arguments, I cannot agree with the more liberal view based on the strength of the market to correct these problems, such as that presented by Benito Arruñada:

> "Let us consider an extreme case in which the law does not provide any system of sanctions against auditors and it is also impracticable to sue them. It is foreseeable that in such a situation there would be greater development of private enforcement and sanctioning instruments. These would be based on the auditor's reputation and the castigation of underperformance through switching decisions. Firstly, there is no doubt that in this situation auditing firms have incentives to develop a good professional reputation since there will be clients who demand auditing with an optimum degree of independence and this would not be the outcome of a very lax legal system. On the other hand, there is no risk that the market will itself generate an excessive level of sanctions, which would be equivalent to a situation of excessively stringent rules, because the market is probably more competent than the legal system when it comes to verifying qualitative information…"

According to Arruñada, regulation should be limited to an indirect intervention to facilitate the work of judicial and market controls – namely by protecting reputation, defining quality standards, producing information relevant to market functioning, and monitoring the compliance with quality standards – further affirming that direct intervention is necessarily inefficient. Although I agree that regulation should reinforce market mechanisms, I do not agree with the suggested limited intervention. In contrast, the argument that stringent regulation will lead auditors to carry "defensive audits" basing their reports on hard information only – creating the risk of less informative reports but which are easier to defend in trial

Besides reputation, 'gatekeeper' liability is the next great incentive for auditors to do a good job.

In the United States, among the causes of the imbalance in auditors' incentives to stop their clients' fraud was the progressive reduction in pressure of litigation.[91] Prior to the 1990's the risk of civil liability was intense, but according to John Coffee[92] several events reduced it:

(a) The Supreme Court decision in Lampf, Pleva, Lipkind & Petigrow v. Gilbertston,[93] which shortened the statue of limitations applicable to securities fraud;
(b) The Supreme Court decision in Central Bank of Denver. N.A. v. First Interstate of Denver. N.A.,[94] which removed the private right of action for "aiding and abetting" liability in securities fraud cases;
(c) The Private Securities Litigation Reform Act of 1995 ("PSLRA"), "which (i) raised the pleading standards to a level well above that applicable to fraud actions generally; (ii) substituted proportionate liability for "joint and several" liability; restricted the sweep of the RICO statute so that it could no longer convert securities fraud class actions for compensatory damages into actions for treble damages; and (iv) adopted a very protective safe harbor for forward-looking information"; and
(d) The Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), which eliminated state court class actions on securities fraud.

For as strange as it may seem, the SOX left this scenario untouched. The legal liability rules remain the same as before the famous scandals and many authors advocate an urgent reform.

In Europe, auditor liability has been discussed since the abandoned proposed Fifth Company Law Directive. Throughout the negotiations of this text the solutions for auditor liability changed as a final agreement on this issue was hard to get. From a strict rule of total harmonization it evolved to a very flexible rule, but even this solution fell apart when the discussions on this proposed Directive were discontinued in 1991.

The initial text of the proposed Fifth Directive provided for unlimited liability of auditors to third parties. This proposal was then revised and the next draft provided

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– seems to be a strong argument to be take into consideration in the drafting of regulatory solutions. See Benito Arruñada, Audit Quality: Attributes, Private Safeguards and the Role of Regulation, at 5-6 and 14-17, Univ. Pompeu Fabra, Economics and Business Working Paper No. 452. Available at http://ssrn.com/abstract=224593 [hereinafter Arruñada, Audit Quality].

[91] The threat of litigation does appear to have a close correlation with the rate and volume of "earnings management." See, e.g., William Heninger, The Association Between Auditor Litigation and Abnormal Accruals. (2001)(finding a positive relationship between measures of earnings management and litigation against auditors). Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=255572. In this article, Heninger finds a positive relationship between measures of earnings management and litigation against auditors. Hence, as litigation risks diminish, accounting irregularities should predictably increase.

[92] See Coffee, Gatekeeper Failure, supra note 17, at 28.

[93] 501 U.S. 350, 359-61 (1991) (creating a federal rule requiring plaintiffs to file their claim within one year of when they should have known of the violation, but in no event more than three years after the violation). Before this case, courts applied state statutes by analogy that often permitted a five or six year delay - if that was the period within which a common law fraud action could be maintained in the particular state.

[94] 511 U.S. 164 (1994).

only for auditor liability to the audited entity. This draft did not include any provision directly imposing liability to third parties, but stated that the established provisions did not exclude auditor liability to shareholders and third parties under the general private law of the Member States. Finally, this draft was further clarified in the Council of Ministers working group, stating that it was up to the Member States to regulate auditor civil liability in order to ensure the compensation of any company, its shareholders or third party for the auditors' wrongful acts. According to this last draft, Member States could limit auditor civil liability for negligence to the audited company by law or allow its limitation by contract.

As this proposed Directive was abandoned, the legal regimes on auditor civil liability continued to differ significantly among the various Member States. The Commission promoted a study on this issue (published in 2001)[95] which concluded that the differences between the Member States' legal regimes included the "legal nature of the liability action brought by the audited company itself against the statutory auditor, which may be either in law or in tort; … the standing of third parties to bring liability actions against the statutory auditor; … the statutes of limitations [that] vary not only by the length of the limitation period, as one might expect, but also by the starting point; [and] the possibilities of limiting liability…, whether they concern legal or contractual liability caps, or forms of legal entities allowed to conduct statutory audits."

3. Should we harmonize? Considering the protection of investors at the center of the debate

The main concerns in the negotiation of auditor liability in the proposed Fifth Directive, as well as in the discussion launched by the Green Paper,[96] were the financial consequences of the different legal regimes for – and possible bankruptcy of – auditors as well as the promotion of an Internal Market for auditing through the freedom of establishment and the freedom to provide cross-border services.

In its 1998 Communication, the Commission noted that a majority of the respondents to the Green Paper expressed the view that harmonization of auditor civil liability "is impossible and unnecessary" but that it received strong representation from the audit profession in favor of initiating action in this area. It was argued that, "from a Single Market point of view, it is important to ensure that different national rules and practices on liability do not create barriers between Member States and that unreasonable claims do not endanger the audit function."[97]

Responding to this situation, the Commission launched its Study on Systems of Civil Liability.[98] This study provides an analysis of the practical effects of the existence of the various statutory auditors' liability systems from the point of view

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[95] See "A Study on Systems of Civil Liability of Statutory Auditors In the Context of a Single Market for Auditing Services in the European Union", January 15, 2001, available at the website of the European Commission, http://europa.eu.int/comm/internal_market/en/company/audit/docs/auditliability.pdf [hereinafter Study on Systems of Civil Liability]. See the conclusion at 111.

[96] See Green Paper, supra note 42, at 28. The first paragraph of the chapter on "Auditor's Civil Liability" states that "Professional liability is an important issue for auditors. In some Member States, audit firms have been made responsible in a number of cases for amounts which were disproportionate with the audit fee and with the auditor's direct responsibility for the financial failure."

[97] See 1998 Commission Communication, at C 143/15.

[98] Study on Systems of Civil Liability, supra note 95.

of the Single Market. However, the practical effects analyzed regard the establishment of auditors in different Member States; the provision of cross border services; and jurisdiction and choice of law issues.[99]

In the 2003 Commission Communication there is nothing new with the exception of the following two sentences:

> "The Commission considers auditor liability primarily as a driver for audit quality and does not believe that harmonization or capping of auditor liability is necessary;" and "There may, however, be a need to examine the broader economic impact of present liability regimes."

Although the 2004 Proposal for a Directive[100] on statutory audit of annual accounts and consolidated accounts, presented by the Commission on March 15, 2004,[101] did not address this issue, the Draft Report of the Committee on Legal Affairs, of the European Parliament,[102] enters the realm of auditors' liability only to suggest a limitation,[103] stating that unlimited liability may force audit firms to adopt risk mitigation strategies, as some can no longer purchase the professional indemnity insurance cover needed to satisfy their unlimited financial liability.[104]

Following these steps we may conclude that generally the Commission (and now also the Committee on Legal Affairs) has been focusing on the economic impact of such legal regimes on auditors and on the construction of an internal market through the freedom of establishment and freedom to provide cross-border services.

I argue that a decision on whether to harmonize the different legal regimes on auditor civil liability should be first and foremost centered on the protection of investors. In the discussion of each specific measure the Commission must consider its economic impact on auditors, but the discussion must be primarily focused on the protection of investors, which is necessary for the creation of a truly unified capital market as envisaged by the Financial Services Action Plan[105].

Considering the protection of investors at the center of the debate, it strikes me that the different legal regimes in the Member States provide very different solutions. These different solutions include manifest and substantial insufficiencies that must be overcome. I agree that "most industrialized countries have given the task of developing principles and rules of auditors' civil liability to the courts, instead of using legislation. This is particularly true with respect to the auditor's

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[99] I shall not discuss the merits of the conclusions of the Study on Systems of Civil Liability, as its premises completely differ from the ones I analyze in this Note. The discussion on such premises would lead me to completely different issues that fall outside the context of this Note.

[100] See supra note 51.

[101] For further details on this Directive, see section 4.1 above.

[102] See supra note 56.

[103] See amendment 133 et seq., proposing a new Art. 30 A, and amendment 144, proposing a new Art.43 A.

[104] See page 32 of this Draft Report.

[105] Regretfully, it is still to be launched a study on the impact of auditors' liability (civil, criminal and administrative) on the protection of investors through audit quality and auditor independence. It should be highlighted that both the Recommendation on Audit Quality and the Recommendation on Auditor Independence miss to refer auditor liability as an important incentive for auditors to comply with the obligations set forth under those recommendations.

liability to parties other than his or her client (i.e., third party liability)."[106] However, the construction of a single capital market in the European Union on the terms set forth in the Financial Services Action Plan is not compatible with the eventual evolution of investor protection through jurisprudence, especially considering that such evolution may differ in Member States with different legal traditions.

Issues such as clarification of the rules according to which investors may sue the statutory auditor (including the establishment of presumptions that assist shareholders of the audited company in suing its statutory auditor) and the promotion of class actions as a mean of overcoming existing agency problems (which keep shareholders from defending their rights as the eventual benefits of the legal proceedings do not compensate its costs) should be promoted by the Commission as a compliment to the adopted measures on auditor independence and audit quality. As a counterbalance, measures on the protection of auditors should be considered in order to avoid excessive litigation. For this purpose I put forward some suggestions on the issues that should be considered by the Commission in the harmonization of the legal regimes of auditor civil liability to investors.

Finally, the alleged "tremendous differences that exist within the EU in this area of the law [that] result not only from different legal traditions but also from different risk allocation and loss distribution techniques and corporate governance structures"[107] should not stop the Commission from acting in the promotion of a true single capital market. The different legal traditions in relation to liability are often represented as an obstacle to any intervention in this area. However the Commission has intervened before in the civil liability area with great success, for example in the area of consumer protection it imposed objective liability of the producer in cases of damage caused by a defective product.[108] This case – auditor civil liability to investors – should be construed as a subcategory within consumer protection, as investors are nothing more than consumers of financial services and the auditor is a provider of such services for their direct benefit.[109]

As for the various corporate governance differences, it should be once more highlighted that the reform of the auditor legal regime has been coordinated with the reform of company law at European level, aimed at harmonizing European corporate governance structures as necessary to create a single Internal Market.

4. Suggestions for harmonization

As I referred to previously, there are some issues regarding auditor civil liability that should be dealt with directly by the European legislators in order to create the necessary conditions for a single capital market in the European Union.

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[106] Werner F. Ebke, Accounting, Auditing and Global Capital Markets, in Corporations, Capital Markets and Business in the Law: Liber Amicorum (Richard M. Buxbaum, ed. by Theodor Baums, Klaus J. Hopt & Norbert Horn, 2000) at 127.

[107] Ebke, The Statutory Auditor's Professional Liability, supra note 89, at 195.

[108] Council Directive 85/374/EEC, of July 25, 1985, on the approximation of the laws, regulations and administrative provisions of the Member States concerning liability for defective products, as amended by the Directive 1999/34/EC of the European Parliament and of the Council of May 10, 1999.

[109] Therefore, harmonization of auditor civil liability should be coordinated with the Consumer Policy Strategy 2002-2006. For more details see the website of the European Commission at http://europa.eu.int/scadplus/leg/en/lvb/l32008.htm.

The suggestions that follow are primarily focused on the protection of investors and only incidentally on the creation of mechanisms that protect auditors from excessive litigation. Only the adoption of the first would justify the adoption of the second set of suggestions, as I believe – in accordance with the data disclosed by the Study on Systems of Civil Liability – that currently the majority of the Member States do not face any problem of excessive litigation that could justify an intervention at the European level. As the tables of the said study illustrate, in the majority of the Member States there was no court intervention at all on such issues as, for example, liability arising out of irregular certification of financial statements (see table on page 43 of the Study on Systems of Civil Liability) or liability arising out of non-disclosure of fraud (see table on page 45 of the Study on Systems of Civil Liability). Consequently, the protection of auditors from excessive litigation must be considered *cum granum salis* and should be balanced with the need to open courts to the claims of investors and the development of adequate deterrence. Some reaction may be necessary in those countries where excessive litigation is a current problem or a potential risk, but that reaction should not be reflected at the European level where the adoption of such limits would create in the remaining Member States at least an additional psychological barrier to the development of shareholder litigation against statutory auditors in breach of their duties, restricting therefore its positive deterrence effect.

The comments provided by Werner Ebke in the Conference promoted by the European Commission on the Role, the Position and the Liability of the Auditor within the European Union held in Brussels in 1996,[110] provided a useful guide to the discussion of the major aspects that were analyzed then and are still analyzed at present. Those major topics include the issue of who should be embraced by the concept of third party entitled to sue the auditor for negligence and how investors' rights should be balanced with the necessary limitation of auditor liability to third parties, considering the standards of culpability, proportional versus joint and several liability, and liability caps.

Thus, we should:

a. Balance the rights of investors and the limitation of auditors' liability

Considering that the requirement that the financial statements of listed companies must be audited by a statutory auditor was primarily established for the protection of investors, at least those who held stock in the audited company at the time of the breach of duty by the auditor should be granted enhanced protection. Therefore, they (a) should have standing in court to sue the auditor for mere negligence[111]; (b) should have the benefit of a presumption that the auditor owed them a duty of care; and (c) should be granted a presumption of reliance on the audit report. This model is a compromise between the protection of investors and the limitation of excessive litigation. This model is not applicable to all those third

[110] Ebke, The Statutory Auditor's Professional Liability, supra note 89, at 195.

[111] As for intentional misconduct, the issue is settled. According to Werner Ebke, " As far as can be seen, under the law of all Member States auditors are liable not only to their client but also to third parties if they intended to deceive the third party or if they acted with reckless disregard of the truth... In some instances, courts have extended this rule to include cases in which the auditor's conduct could be qualified as gross negligence." Ebke, The Statutory Auditor's Professional Liability, supra note 89, at 197.

parties allegedly affected that cannot present proof of holding stock in the audited company during the relevant period that follows the disclosure of the misleading audit report, nor does it exclude them from the general tort or contractual rules applicable in the different Member States. It is therefore centered on the intended primary beneficiaries of the mandatory audit.

According to Werner Ebek,

> Comparative legal research strongly suggests, however, that the law should not allow all generally foreseeable third party users of certified financial statements to sue the auditor for ordinary negligence. Such a 1iability model would ultimately cause more harm than good. Economic studies indicate that the process of expanding auditors' liability for ordinary negligence to all generally foreseeable users of certified financial statements is one of socializing losses and individualizing profits. The distribution of losses from the individual user to the public, with its enormous transaction costs for society, is legally, economically and socially not sound because the corresponding gains to the public are marginal.[112]

Even though I acknowledge the fairness of this comment I must present two further considerations. First, the model referred to above does not extend standing to "all generally foreseeable third party users of certified financial statements." Its limits are clear and are easily applicable, as it refers only to investors who held shares during the relevant period and clearing houses can provide records of the holding of stock during that period. Second, although this model may extend the array of potential plaintiffs in many Member States creating the inefficiencies referred by Werner Ebek, its results in terms of the immediate protection of the rights of investors and as a deterrent may counterbalance or even outweigh such inefficiencies from a policy point of view. In fact, the enactment of these rules at the European level – which would create the necessary level playing field to provide investors with certainty about their rights – in conjunction with adequate rules on class actions[113] could increase the potential of litigation as a deterrence mechanism[114] and could definitely contribute to an adequate defense for investors' rights.

In the same text, Werner Ebke further states that "the public will be best served if the law keeps the liability of auditors' to third parties within reasonable and insurable limits. The liability of auditors to third parties can be most effectively limited by raising the standard of culpability. Thus, an auditor should be held liable to third parties only if he or she acted with the intent to deceive the third party or if he or she acted with reckless disregard of the truth (which in some cases may include grossly negligent conduct on the part of the auditor)."[115] Although I fully agree with the first sentence I cannot agree with the solution suggested in the second one. I do believe that the system will only work for the benefit of investors individually (i.e. in each specific case where an investor was damaged by the auditor's conduct and seeks remedy in court) and collectively (i.e. by the improvement of audit quality and auditor independence through the reinforcement of the deterrence effect of litigation) if litigation does not drain auditors' funds to the point of making their activity

[112] Ebke, The Statutory Auditor's Professional Liability, supra note 89, at 198.

[113] See para. (ii) infra.

[114] There is a potential risk of falling in the other extreme, i.e. excessive litigation. To provide an adequate balance I suggest the creation of a cap on auditor civil liability as described infra.

[115] Ebke, The Statutory Auditor's Professional Liability, supra note 89, at 200.

unattractive. I believe that all investors who held stock in the relevant period following the misleading auditor report should have the right to defend their rights against the negligent auditor. Thus, the raising of the standards of culpability would deny most investors an adequate remedy for the violation of their rights, as the intention to deceive is almost impossible to prove in court by a common investor.

Another limitation defended by Werner Ebke (and also by André Bindenga in another paper submitted to the Conference above referred[116]) and, I suppose, by the auditing profession, is the limitation of auditors' responsibility in proportion to their fault. The adoption of proportional liability[117] in replacement of joint and several liability would implicate the allocation of liability between the audited company's management and the auditor. According to Auditors, "proportionate liability introduces a greater degree of fairness, it will discourage inflated claims, and it will encourage everyone to be aware of their responsibilities."[118]

The problem that led to auditors' complaints is that once the audited company is facing bankruptcy, everyone turns to the auditors' "deep pockets". Especially in the United Kingdom, there was a significant increase in lawsuits against auditors, paralleled by an increase in out of court settlements,[119] meaning that there is a lack of precedential case law dealing with this situation.

G.P. Stapledon wrote an article in 1993 on the AWA case[120] decided by the Supreme Court of New South Wales, Australia, where he considered, among other issues, the position of the court on the availability of contributory negligence as a defense for auditors. In this case, based on a "respectable body of authority" in Australia and in the United States, the court stated that "a defense of contributory negligence against a company, based on the allegedly negligent conduct of a servant or director, is not available to an auditor whose duty is to check the conduct of such persons."[121]

The reasoning of the court seems clear and convincing. Auditors have a duty to check the conduct of managers as reflected in the financial statements. The adoption

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[116] André Bindenga, The Statutory Auditor's Professional Liability, in Act of the Conference on The Role, the Position and the Liability of the Statutory Auditor within the European Union, December 5 and 6, 1996, at 195. Available at the website of the European Commission, http://europa.eu.int/comm/internal_market/en/company/audit/docs/acten.pdf.

[117] The discussion is on the allocation of liability between the auditor and the audited client. As for the allocation of the liability between the audit partner and its firm, the best solution is the "joint and several" liability. The audit firm may be forced to pay for the damages caused by the audit partner negligent conduct as the client and investors rely on the services provided by the firm as a whole and not on the specific audit partner that represents the company. Once it has paid for damages, the audit firm shall be entitled to claim from the partner the amounts paid. This solution has been criticized by some auditors that are not incorporated and are afraid to see their personal assets affected by the negligent conduct of one of their partners. Incorporation is therefore the solution sought by auditors, so that the conduct of one partner cannot affect more than the assets of the audit company.

[118] See Ian Brindle, The Statutory Auditor's Professional Liability, in Act of the Conference on The Role, the Position and the Liability of the Statutory Auditor within the European Union, December 5 and 6, 1996, at 195. Available at the website of the European Commission, http://europa.eu.int/comm/internal_market/en/company/audit/docs/acten.pdf.

[119] Lawsuits' costs to the auditors in time, money and reputation makes settlements an attractive solution, even in cases where they could sustain a good defense.

[120] AWA Ltd. v. Daniels, 7 ACSR 759. See G.P. Stapledon, The Awa Case: Non-executive Directors, Auditors, and Corporate Governance Issues in Court, in Contemporary issues in corporate governance (1993) / edited by D. D. Prentice and P.R.J. Holland, at 186 [hereinafter Stapledon, The Awa Case].

[121] AWA Ltd. v. Daniels, 7 ACSR at 842. See Stapledon, The Awa Case, supra note 120, at 196.

of proportionate liability would deny this duty, isolating auditors' negligence from managers' fault, when in fact they must be intrinsically linked. For this reason, I believe that the limitation of auditor liability cannot be achieved this way either.

The last, and preferable, way to limit auditor liability is to statutorily establish liability caps. I think that, being the best solution to this problem, liability caps should be flexible in order to reflect the financial position of both the auditor and the audited company.

Currently there are three countries in Europe with legal liability caps: Germany, Austria and Greece.[122] Austria and Germany have fixed limits of approximately 363,400 Euro[123] and 1,000,000 Euro[124] [4,000,000 Euro[125] for stock corporations with issued stock with official rating (*Notierung*)] per audit respectively. In both cases the limits apply regardless of the number of persons conducting the audit and the number of acts or omissions causing the damage. Greece has a more flexible system, whereby the auditor's liability per breach of duty cannot exceed an amount equal to five times the annual salary of the President of the Supreme Court or the total amount of fees received in the previous year, whichever is higher. These caps apply to the claims of the audited client and third parties, except in Germany where this issue has not yet been settled.[126]

Fixed caps such as those adopted in Austria and Germany are not adaptable to the financial strength of each auditor. Hence, the same cap might be too small for a large audit firm with dozens of associates working on each case and might be enough to cause serious damage to a small firm. Likewise this kind of solution is not adaptable to the audited client. The same audit firm might provide audit services to both small and large companies. The cap might end up being too small for the damages caused to investors while auditing a large public corporation but too disproportionately large relative to the services provided to a small client.

A possible flexible solution should consider not only the determination of a cap but also its correlation with a mandatory and adequate insurance policy. I suggest (i) the determination of the liability cap per audit by multiplying the highest revenues received from the audited company in a certain number of years by a predetermined

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[122] A proposal of the Belgium government for the enactment of legal liability cap for auditor civil liability was declined by the Belgium Parliament on the basis of the difficulty to create an exception to the general rules of civil liability.

[123] As of January 2001.

[124] As of January 2001.

[125] As of January 2001.

[126] In accordance with German law third parties such as investors are not directly entitled to sue the auditor for negligent conduct, except where a claim is made on the basis of a contract with intended third party beneficiaries. In these cases the question of the application of the liability cap has not yet been settled (as of January 2001). The Study on Systems of Civil Liability, supra note 95, at footnote 107, provides a clear explanation of the state of this discussion as of January 2001: "In its decision of 2 April 1998 (NJW 1998, p. 1948) the Supreme Court stated that Article 323 HGB does not exclude possible liability of statutory auditors under a contract with protective effects to third parties. supra p. 25. At the same time the Court considered that the limitation of liability in Article 323 HGB must be taken into consideration in the relationship between the auditors and the third party. Some authors conclude that the limitation is generally applicable. Sieger/Gätsch, BB 1998, p. 1408. A good reason for such application seems to be that, otherwise, the third party would profit by a higher amount than the audited company itself, which paid for the audit. However, the District Court of Passau expressed the contrary opinion in a recent decision. The Court reasoned that the cap from Article 323 HGB is not applicable to contractual liability towards third parties. LG Passau, 28 May 1998, not final, BB 1998, 2052."

multiple;[127] and (ii) the regulation of mandatory insurance coverage for the performance of audit services [128] at a minimum level, coupled with the determination of a mandatory range of deductibles as a percentage of the claim.

As for the first element, this solution presents several advantages, especially when compared with the German and Austrian solutions. First, it would create a flexible mechanism adapted to the auditor and the reality of the audit client through their interaction in the market, reflected by the amount of fees paid. Second, this solution would ultimately allow auditors and their insurance companies to calculate ratios of maximum possible liability, and determine adequate insurance premiums. Third, this solution has the advantage of potentially preventing auditors from passing the insurance premiums on to their audit clients through fees charged, obliging auditors to internalize the cost of their potential negligence. In fact, this system creates an incentive for auditors to internalize that cost, because if the premiums are reflected in the fees paid by their clients, they will be raising the level of future liability as the cap depends on the amount of those fees. Fourth, by setting the cap as a percentage of the highest fees collected from the audited client, there is no need to frequently reevaluate the cap to respond to inflation and evolution of the market. Finally, this proposal would be adaptable to each Member State as a Directive could leave up to their decision the definition of an adequate multiple within a predefined range.[129]

As for the second element of the proposal, the fixed range of deductibles would ensure (i) that part of the claim will effectively be paid by the auditor (maintaining the deterrent effect[130]); (ii) that the payment is proportional to the claim[131] (assuring a correlation between the consequences of its negligent conduct and the payment) and (iii) that auditors will not negotiate high levels of deductibles (assuring their financial stability and that they do not use deductibles as a way to reduce the premiums, which are used for the calculation of the liability cap).

To conclude this section, I must highlight one final issue. In some Member States it is possible for the auditor to agree with the audited company on a limit to his liability. However, such an agreement could never affect the rights of third

[127] This solution presents some similarities to the Greek one, as the cap is set per audit instead of per breach, it allows more certainty as to the maximum amount the auditor may be held liable for in each year. The said certainty facilitates the purchase of adequate insurance.

[128] In most Member States insurance coverage is already required by law (Austria, Denmark, France, Germany, Greece, Italy – auditing firms, Nederlands, Portugal, Spain, Sweden), or by the professional organizations (Belgium, Ireland, United Kingdom).

[129] The determination of the cap based on a multiple of the highest annual revenue received by the auditor from the audited client was based on arguments presented by John Coffee in his proposal for the implementation of auditor strict liability backed by an insurance policy caped at a realistic level. For more details see Coffee, Gatekeeper Failure, supra note 17, at 67.

[130]A common problem identified by one speaker at the Conference on the Role, the Position and the Liability of the Statutory Auditor within the European Union indicated that "if a claim does result in litigation, the Court will first find out to what extent it is covered by insurance. The Court will then award the claim for the amount insured plus a surcharge, since the auditor must, after all, be punished for his professional error." This position was transcribed in the Study on Systems of Civil Liability, supra note 95, at 81.

[131] In Europe, Member States have implemented different methods for calculating the amount of the maximum deductible. For example, in Germany, deductible is determined by reference to the minimum coverage. In France is by reference to the claim and in the United Kingdom (for the Institute of Chartered Accountants of England and Wales) varies with the size of the firm. For more details see the Study on Systems of Civil Liability, supra note 95, at 85.

parties to claim damages from the auditor. In fact, in all those Member States that allow contractual limitation of liability, i.e. Denmark, Luxembourg, Netherlands, and Spain, such limitations have no effect on third parties.[132] Hence, further discussion of this issue is beyond the scope of this Note.

b. Promote class actions

Class actions have their origin in the United States where they were introduced to overcome agency problems related to the dilution of share capital in the hands of investors in the market. Basically an investor who holds a small percentage of the share capital of a company will lack the incentive to sue, for example, the management for breach of their fiduciary duties, because he would bear the full cost of the proceedings while the benefits would be collected by all shareholders. Furthermore, a single shareholder has less leverage to press management in the right direction. This type of collective action allows holders of the same class of shares to share the costs of the legal proceedings which will benefit them all. In addition, together they will have more power to pressure management.

In Europe, class actions are currently allowed only in Portugal.[133] However, even in Portugal this mechanism has never been used in the field of statutory auditing.

Even though class actions present clear benefits in terms of overcoming agency problems associated with shareholder litigation and in multiplying its deterrent effects,[134] the introduction of such a mechanism at the European level should not be limited to such a limited matter as shareholders' claims for auditor civil liability. Therefore, in this Note I shall do no more than reflect on the general advantages and disadvantages of the application of this mechanism in this field. Major advantages include the possibility (i) of overcoming agency costs of individual litigation of one shareholder against the auditor and (ii) of increasing shareholder leverage against the auditor (that might be reflected in an eventual settlement).

The major disadvantage is the risk of frivolous and excessive litigation. I think that this would not be a material problem in Europe as both the prohibition of *quota litis* agreements – generally imposed on European lawyers – and the establishment of adequate liability caps reduce dramatically the incentives to abuse this mechanism.

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[132] The discussion on the contractual limitation of liability by the auditor and audited company falls out of the scope of this Note, although I must say that many critics can be pointed beyond the traditional argument that auditor liability towards the company is of public interest and thus cannot be limited by agreement between those two parties. For example, one of the possible problems is that auditors may be more easily convinced to be lenient with the fraudulent practices of their clients' managers, if the latter agree to limit the auditor's liability to the company. In a case where fraudulent practices are detected and the responsible managers are replaced, the replacing managers would find it difficult to sue the auditor for the total amount of damages which even tough were caused by the former management, were only possible by the auditor's aiding and abetting.

[133] See the legal regime of the "Acção Popular" set forth by Law no. 83/95, of August 31, 1995. It provides among others, for "the protection of consumers of goods and services (Art. 1 para. 2). The Securities Act ("Código dos Valores Mobiliários"), approved by the Decree-Law no. 486-99, of November 13, 1999, deals with the rights of investors and completes Law no. 83/95.

[134] The development of shareholder litigation through class actions would create a control over corporate disclosures parallel to the control of the regulatory entities, potentially increasing investor confidence in the market. This fact could be of the utmost importance in countries that traditionally rely almost exclusively on public authorities for the control of wrongdoing.

The success of class actions in the United States (or as many would say, the excessive success) is due in part to the role of attorneys. Unlike their European colleagues, US attorneys are not subject to a prohibition of *quota litis* agreements. In fact, contingency fees are the driving force for a great part of the litigation promoted by US lawyers in the field of corporate law.

In Europe the prohibition of *quota litis* agreements helps to keep litigation to acceptable levels but in the case of class actions it might actually prevent them from working. If the main incentive for the promotion of class actions is not present in the European system, this mechanism might simply not function as occurred in Portugal. Thus, the implementation of class actions in Europe might have to be followed by the creation of adequate incentives for shareholders to use this mechanism.

c. Promote Derivative Actions

One of the most striking limitations of European corporate law for someone who is used to the American system might be the absence of derivative actions – i.e. suits brought by a stakeholder on behalf of the corporation against a third party when the corporation itself fails to take some action against that third party – in many Member States. According to the Study on Systems of Civil Liability, only five Member States allow derivative actions. In Portugal, Spain and the United Kingdom these actions may be brought only by shareholders and in Italy and Luxembourg by shareholders and/or creditors.[135]

What I said above regarding the introduction of class actions in Europe applies likewise for directive actions, i.e. their introduction at the European level should not be limited to such a limited matter as shareholders' claims for auditor civil liability, and the advantages and disadvantages usually raised in the discussion of this corporate governance mechanism are generally applicable here.

The implementation of this mechanism in this field would be extremely useful, especially in cases where the auditor's breach of its duties to the audited client might consist of acquiescence to the managers' wrongdoing. In these cases, managers will not protect the company's interests but their own, not suing the auditor as they should. Therefore, shareholders should be allowed to intervene on behalf of the company.

5. Note on the importance of the procedural rules

Notwithstanding all of the issues considered above, one should question whether harmonization of the substantive law of auditor liability would alone be sufficient to increase the protection of investors. The fact is that even considering the adoption of perfect substantive rules, the relevance of procedural law and procedural environment cannot be overlooked. As Werner Ebke refers, "the availability of pre-trial discovery and the existence of class actions of derivative law suits have as much an impact upon the outcome of a law suit against auditors as do the rules on the allocation of the burden of proof and the existence of a right to a trial by jury. Likewise, the rules on the cost of litigation and the ultimate liability for the parties'

[135] For more details see the Study on Systems of Civil Liability, supra note 95, at 25.

attorneys fees also determine the effectiveness of substantive liability rules and principles."[136]

Even though I agree with this analysis of Werner Ebke, I cannot agree with his conclusion that "harmonization of the substantive law of auditors' civil liability can accomplish its goals only if the Member States' rules of civil procedure are harmonized at EU level as well." I believe that there are several degrees of accomplishment of the objectives envisaged with the harmonization of auditor liability regimes. I accept that a full accomplishment of such objectives would necessarily depend on the harmonization of procedural rules[137]. However that does not mean that a progressive harmonization on this issue should not be attempted. Even knowing that the result will not be one hundred percent satisfactory the Commission should not resign from creating the necessary conditions for the uniform protection of investors in a true Internal Market.

6. An overview of the discussion on strict v. negligence-based liability

In the United States several authors[138] have been discussing the merits of strict liability for auditors (and other gatekeepers).

Although I believe that Europe is not – and will not soon be – prepared to impose strict liability on auditors, the authors involved in this discussion have presented extremely interesting arguments. Thus, considering the weight of US influence over the European discussions in this area, I will very briefly introduce this discussion.

According to Frank Partnoy's theory, "gatekeepers would be strictly liable for any securities fraud damages paid by the issuer pursuant to a settlement or judgment. 'Gatekeepers' would not have any due diligence-based defenses for securities fraud. Instead, 'gatekeepers' would be permitted to limit their liability by agreeing to and disclosing a percentage limitation on the scope of their liability for the issuer's damages."[139] Partnoy based this proposal on the need to face the costs related to the 'gatekeeper' role in securities fraud, including "both the costs of behavior designed to capture the benefit of due diligence-based defenses and – more importantly – the costs of resolving disputes about gatekeeper behavior."

John Coffee, on the other hand, starts by basing his approach on the following considerations presented by Assaf Hamdani: Strict liability has two basic advantages

[136] Ebke, The Statutory Auditor's Professional Liability, supra note 89, at 198.

[137] In fact, I believe that true accomplishment of the objectives depends on much more than the mere harmonization of substantive and procedural rules. Such factors such as corporate governance structures and the capital market environment – which may determine the predisposition of an investor to sue an auditor – or jurisprudence – which may determine the different interpretation of the common rules – are simple examples of factors that may create obstacles to the full accomplishment of the objectives envisaged. The best example that substantive rules are not auto-sufficient is the Portuguese economic reality. Portugal is often pointed as having some of the most advanced substantive rules and nevertheless its capital market is one of the least relevant in the European Union.

[138] See Frank Partnoy, Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime, 79 Wash. U. L. Q. U91 (hereinafter "Partnoy, Barbarians at the Gatekeepers?"); Assaf Hamdani, Gatekeeper Liability, Harvard Law and Econ. Working Paper 2003 No. 442, 77 S. Cal. L. Rev. 53, Available at http://ssrn.com/abstract=466040 [hereinafter Hamdani, Gatekeeper Liability]; Stephen Choi, Market Lessons for Gatekeepers, 92 Nw. U. L. Rev. 916; and Coffee, Gatekeeper Failure, supra note 17.

[139] Partnoy, Barbarians at the Gatekeepers?, supra note 138, at 516.

over negligence-based liability.[140] "First, it would provide wrongdoers with optimal incentives to exercise precautions while relieving courts from entering the thicket of determining what constitutes 'reasonable care' in a given set of circumstances. Second, strict liability compels wrongdoers to adopt an optimal level of activity." On the other hand, 'gatekeepers' would raise their fees to cover the risk increase, passing the cost of such a solution onto the audited companies. According to John Coffee, "This increase is presented as one of the attractions of this approach because it forces the client that cannot convince its auditor that it presents a low risk of fraud or material error to bear a higher fee. In a perfect market, the issuer would thus bear the expected social cost of the fraud, which would in turn imply that the only issuers that could access the market would be "those for whom the value of the public financing exceeds the harm caused by fraud"[141]. However, as Hamdani highlights, this system would be very costly to implement because it would be very difficult for auditors to determine ex ante which clients are potential wrongdoers, thus keeping them from setting individual fees for their clients in accordance with the risk of misconduct. The result is that "they will charge all issuers a fee based on the average likelihood of fraud by unseasoned companies as whole," which will affect all the market and will not keep out the potential wrongdoers.[142]

Acknowledging the foregoing problem,[143] John Coffee suggests the conversion of the auditor "into a functional equivalent of an insurer, but one who backs certification with an insurance policy that was capped at a realistic level." The cap proposed would correspond to an "adequate multiple of the highest annual revenue received by the gatekeeper from its client over the last several years."

John Coffee himself explained the major differences between his theory and Frank Partnoy's: "(1) Professor Partnoy's system is essentially contractual, while this proposal is essentially regulatory; (2) Professor Partnoy uses a percentage of the damages as its potential minimum floor, while this proposal uses a multiple of the gatekeeper's highest annual revenues from the client; and (3) while the potential damages, as calculated under Professor Partnoy's proposal, could often bankrupt the gatekeeper, bankruptcy would rarely follow when a multiple of the revenues from the client generated the required minimum floor on the gatekeeper's insurance obligation.[144]

The arguments presented on both sides of the discussion are very interesting, but considering that the application of such kind of system would not currently be possible in Europe, they fall outside of the scope of this Note.

V. CONCLUSION

In this Note I have considered the role of auditors as 'gatekeepers', the evolution of their legal regime and the reforms that have taken and are taking place on both

[140] See Hamdani, Gatekeeper Liability, supra note 138, at 5; Coffee, Gatekeeper Failure, supra note 17, at 64; and Partnoy, Barbarians at the Gatekeepers?, supra note 138, at 514.

[141] Coffee, Gatekeeper Failure, supra note 17, at 64. On similar terms see Hamdani, Gatekeeper Liability, supra note 138, at 6.

[142] For more details see Hamdani, Gatekeeper Liability, supra note 138, at 6.

[143] And others. For more details see Coffee, Gatekeeper Failure, supra note 17, at 65-67.

[144] For more details see Coffee, Gatekeeper Failure, supra note 17, at 69.

sides of the Atlantic following the financial scandals that started emerging in 2001 and continue to overshadow capital markets around the world.

In particular, I have looked at the European reform process and concentrated on two major aspects that in my opinion are the most urgent reforms to ensure that auditors will adequately perform their role as gatekeepers: auditor independence and civil liability to investors.

As for auditor independence, the efforts of the European Commission throughout the years were reflected in the Recommendation on Auditor Independence and more recently in the Proposal for a new directive regulating auditors. I have analyzed step by step each of the major aspects of the enacted reforms – such as those regarding the audit committee, the relationship between the auditor and its client, the rotation of auditors and the provision of non-audit services to audit clients – considering European and American doctrines and providing my own perceptions on the solutions that should be adopted.

As for Auditor civil liability to investors, I cannot agree with the conclusion of the Commission that harmonization is not necessary at this moment. On one hand, it seems clear that in the real world reputation does not provide enough motivation for auditors to comply with their duties and that an adequate system of liability must be put in place to reinforce that market incentive. On the other hand, considering that (i) statutory audits are an instrument of public interest, especially in relation to listed companies – as the individual rights of investors and the stability of the market depend on the transparency of the companies guaranteed by trustful disclosure – and that (ii) the protection of minority shareholders is an essential condition for the development of a true single capital market within the European Union, investors should be allowed to defend their rights against negligent auditors.

For these reasons, I present my suggestions for the harmonization of European regulation of auditor civil liability centered on the protection of investors. According to my view, investors who held shares in the audited company during the relevant period following a misleading audit report should have standing in court to sue the auditor for mere negligence and should benefit from a presumption of the auditor's duty of care to them and a presumption of reliance on the audit report.

Acknowledging the risks of excessive litigation (which are already a reality in the United Kingdom) I further suggest the limitation of auditor liability through a legal liability cap and adequate insurance. The cap per audit would be determined by multiplying the highest revenues received from the audited company in a certain number of years by a predetermined multiple. Adequate insurance would depend on the requirement of mandatory insurance coverage at a minimum level for the performance of audit services, coupled with the determination of a mandatory range of deductibles as a percentage of the claim.

Financial scandals may take place in Europe too – as Parmalat insisted on reminding us – and auditors, as well as other gatekeepers, should do a better job to prevent them. The European Union is moving in the right direction in relation to audit quality and auditor independence, although I criticize some specific actions, but a radical change of attitude is needed to make auditor civil liability towards third parties a reality. The creation of a single capital market depends on that.