

Tort liability of accounting firms for securities misrepresentation

Yuting Wang *

School of Law, Nankai University, Tianjin, China

*Corresponding author: 1813224@mail.nankai.edu.cn

Abstract. A securities misrepresentation tort case could be complex since it not only involves multiple subjects but also involves some reasonable presenting documents mixed-use, which makes it difficult to delineate the liability based fully on the evidence. What is a fair way to distribute liability in a securities misrepresentation tort case where the disclosure obligor knowingly provided false audit material and the accounting firm failed to effectively identify it? This paper, using case study approach and comparative study, after a comparative analysis between the relative regulations of the US and China, indicates a tendency of proportionate joint and several liability and further proposes steps to develop proportionate joint and several liability for accounting firms. The limitation of the liability of accounting firms is not for self-protection but to align the interests of issuers with those of listed companies, securities intermediaries, and investors.

Keywords: Securities misrepresentation; joint and several liability; accounting firm; proportional joint and several liability.

1. Introduction

The general background of the reform of the registration system for securities issuance in China has placed higher demands on the verification duties of intermediaries such as accounting firms. Meanwhile, the new Securities Law, the amendments to the Criminal Law (XI), the new "Misrepresentation Provisions" and other amendments have also further consolidated the legal responsibilities of accounting firms as gatekeepers [1] of the capital markets. This is an important measure to increase the cost of violations and deter violations in cases of malicious collusion between information disclosure obligors and securities intermediaries, but an excessive penalty when the disclosure obligor knowingly provides false audit material and the accounting firm fails to effectively identify it.

In the operation of the capital market, controlling shareholders and effective controllers have control over the issuer, hold all information about the issuer and play a decisive role in the process of issuer disclosures, while accountancy firms are stuck by information barriers and audit cost controls. This is the purpose of this article: to question the rationale and social effect of the existing legal provisions on joint and several liabilities.

2. Status quo of liability of accounting firms

2.1 Sorting out the regulation of joint and several liability for accounting firms

Joint infringement by the intentional disclosure obligor in combination with the negligence of the accounting firm just matches the condition designed by the Civil Code of the People's Republic of China, which says "Where the tortious acts committed by two or more persons respectively cause the same damage to another person". However, the act of the accounting firm is hardly "sufficient to cause the entire damage independently", which means there is no sufficient basis to hold the accounting firm jointly and severally liable according to Civil Code. This article argues that to combat financial fraud and safeguard the legitimate rights of investors, the securities laws and regulations, as a special law, have constructed their own system.

Comparing a total of six editions of the Securities Law in 1998, 2004, 2005, 2013, 2014, and 2019, after 24 years of development, the thinking behind the Securities Law on joint and several liability of securities service providers and listed companies have not changed.

2.2 The drawback of undertaking the common tort liability by accounting firms

2.2.1 Betrayed the jurisprudential principle of proportionality of responsibility

Jurisprudentially, there is one of the principles of imputation, the proportionality of responsibility, ensuring the liability can be reasonably attributed. This principle requires that the degree of legal liability should be commensurate with the damage caused by the violation, the degree of subjective fault of the perpetrator, and the causal force of the perpetrator's violation [2]. In some instances, accounting firms have materially departed from the principle of proportionality when they have been held liable for damages beyond their knowledge and control.

2.2.2 Betrayed the social effect of protecting the interests of investors

Accountancy firms bear the same legal consequences regardless of their subjective mindset, while having a catalytic effect in both positive and negative directions: on the one hand, it would urge some firms to adopt more conservative audit strategies, which increases the burden of audit costs for quality listed companies and making investors miss out on some quality investment possibilities. On the other hand, it would prompt some firms voluntarily violate practice standards to gain further business benefits [3]. At this point, the distinction between liability for malicious collusion and audit negligence is instead a more meaningful guide.

2.2.3 Magnifying tendency

In civil liability disputes for securities misrepresentation, the review of whether the accounting firm has exercised due diligence has a "hindsight" tendency; the liability of the accounting firm has a "deep pocket" tendency. First, let's discuss hindsight. Where a misrepresentation has already been discovered, the court deduces from the result to the cause, which is likely to be plagued by cognitive bias and concludes that it is not fair to the intermediary. To be brief, inclined to evaluate accountancy firms as inadequate or insufficient [4]. Then, let's move on to "deep pocket", which means a handful of courts allow to connect the innocent but rich defendant to the plaintiff's alleged harm [5]. This is to some extent understandable, after all, someone must pay. In 2014, the Iowa Supreme Court called out these types of end-game-oriented rulings as "deep-pocket jurisprudence", and stated which ruling is law without principle [6]. As a result of the deep tie between liability and the ability to indemnify, accounting firms are caught up in litigation not because they are at fault, but because they have the resources.

3. Path options for limiting the liability of accounting firms

Moreover, Ronald H. Coase provided another reliable analytical tool - transaction costs [7]. In the current system of rules, there are only two levels of liability for accounting firms: no fault and no liability, and full joint and several liability for investors' losses without distinction. As a result of this "all or nothing" tendencies described above, accounting firms are relatively unlikely to "escape".

Although the accounting firm will be able to recover from the issuer of the securities or the listed company under Article 178 of the Civil Code after assuming joint and several liability, it is highly likely that the accounting firm will then be faced with an emptied pocket. This phenomenon, in which the responsible person may be liable for a share of ultimate responsibility that does not belong to him or her, is objectively widespread and is referred to by Professor Wang Zhu as "risk liability" [8]. How an accounting firm is liable to third parties directly determines the extent of its liability for risk. This article argues that liability should be appropriately determined to ensure that investors are adequately compensated and to prevent an accountancy firm with minimal ultimate

liability from being exposed to significant risk liability for its minor negligence. At present, there are two broad path options for limiting the liability of accounting firms.

3.1 Unreal joint and several liability

Some scholars advocate that the accounting firm bears an unreal joint and several liability, "regardless of whether the law or judicial interpretation explicitly provides for the right of recovery, the securities intermediary should be entitled to exercise the full amount of the right of recovery from the ultimately liable person, i.e. the issuer or listed company, after it has assumed the liability for damages" [9]. Intermediaries who are only negligent but not intentional, even if they are jointly and severally liable, do not have to admit their fault and can continue to recover from the issuer for their ultimate liability [10].

This path of limiting liability faces several challenges: on the one hand, as the rules above have sorted out, the current laws and regulations consider accounting firms to be culpable for issuing inaccurate audit reports due to negligence, and there is no institutional scope for bona fide joint and several liability. On the other hand, it appears that joint and several liability does not alleviate the abnormally high risk liability burden.

3.2 Proportional joint and several liability

Proportional joint and several liability, or "joint and several liability with limitations" [11], is still belonging to joint and several, and the intermediary is externally liable to all right holders in no particular order, to which a "proportional" limit is added, adjusting the scope of the external compensation to the part related to its own liability only.

The superiority of proportionate joint and several liability over other forms of liability lies in the fact that the adequacy of the basis of liability directly determines the scope of damages. At the same time, the discretionary power given to the judge in respect of the scope of liability ensures that the outcome of the decision is appropriate and that a degree of legal certainty is achieved [12].

4. Steps to assume proportionate joint and several liability by an accounting firm unfold

This article argues that it is important to recognize proportionate joint and several liability based on the institutional norms already in place. The audit of financial data involves a great deal of subjective professional judgment on the part of the accountant and is not mechanical [13]. There is also always an objective "expectation gap" where the public expects more from a CPA than the CPA is capable of. Therefore, full joint and several liability should be applied judiciously and proportional joint and several liability should be expanded in trials.

4.1 Setting the burden of proving the element of causation

It has been observed that sooner or later most of those who are interested in the law of torts turn their attention explicitly to the subject of causation [14]. As mentioned above, the scope of proportionate joint and several liability for external indemnity is only for the part related to one's liability, and therefore a fine distinction should be made between the scope of liability of the listed company and the scope of liability of the accounting firm. Competent plaintiffs have been identified in the course of securities misrepresentation tort proceedings. On this basis, the element of proof of causation, whereby investors rely to some extent on the audit report for their investment decisions, is set up, thereby separating the portion of investors who have the right to claim against the accounting firm. As an example, requiring an audit report containing a false statement, misleading representation or material omission to be issued before the investor holds the securities will, to some extent, avoid undue amplification of the scope of the accounting firm's liability.

4.2 Expanding the scope of the no-fault determination

The Basic Standards for Independent Auditors were formulated by the Chinese Institute of Certified Public Accountants and approved for issue by the Ministry of Finance as departmental regulations issued by the Ministry of Finance with the force of law. It is a relatively unrealistic level to elevate the liability of the average professional for negligence in the practice of law to the level of an expert [15]. For example, where there is a minor procedural defect in the work of the securities services provider, but the misrepresentation would have been difficult to detect even if the relevant procedures had been carried out in full, the court should find that it was not at fault. A securities service provider shall also be found not at fault if its work causes only minor data errors that do not materially affect investors' decisions or the market price of securities [13].

4.3 Reasonable proportion of responsibility

If the accounting firm is indeed negligent in issuing the report, the specific percentage of liability must be determined by a combination of factors such as the degree of fault, the force of the cause, and the degree of expertise. The judiciary has correctly determined the liability of different functional intermediaries and their limits, and has confronted the limited function of intermediaries in preventing misrepresentation with a reasonable liability model.

5. Conclusion

This essay is dedicated to conveying the idea that healthy and stable financial markets are of the first order, and a fair and reasonable distribution of responsibilities is of the second order. In a regulated, transparent, and open securities market, the interests of issuers and listed companies, securities intermediaries, and investors are aligned therefore it is not a "zero-sum game". The aim of the attempt to narrow the liability of accounting firms is far more than selfish, but is to better build order in the capital markets.

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