Testimony of
Michael R. Young
Willkie Farr & Gallagher LLP

Before
The Department of the Treasury
Advisory Committee on the Auditing Profession

Chairmen Levitt and Nicolaisen and members of the Committee, I am Michael Young, a partner at Willkie Farr & Gallagher. I am pleased to have been asked to make this submission to the Committee regarding that aspect of the auditing profession dealing with its firm structure and finances. In particular, I will speak to key issues the firms face in litigation as presently conducted in the United States.

I have spent the bulk of my career working with, and defending, the auditing profession, and I believe I have a fair sense of the core problem the profession faces in litigation. And I should make clear at the outset that the litigation to which I refer are the large-scale cases typically brought in the aftermath of a significant business reversal or bankruptcy. That is, I seek to address mainly securities class action litigation involving the audits of financial statements of public companies.

I begin with the proposition that the core problem is not, as some might fear, that the litigation system is somehow skewed against the auditing profession. Nor is the problem that the kinds of issues ordinarily involved in an audit case are too complicated or sophisticated for a typical jury. It is true, no doubt, that an audit case will usually involve exceedingly complex matters. But my own experience is that juries work hard to understand such things, apply their common sense, and come to determinations that, if not perfect, are within the realm of a sensible result.

The problem is not that our system of justice doesn't work with regard to the auditing profession. The problem is that, with regard to the auditing profession, the potential damages are so staggering that the profession cannot take advantage of its day in court.

Let me explain what I mean. At the core of our system of justice is a trial, normally before a jury. A trial is, in my experience, a great engine for the discovery of the truth. However, it is never without risk. A sleep-deprived witness might stumble, a prejudiced juror might disregard the evidence, complicated aspects of the law may be misinterpreted. The list of things that can go wrong, no matter how strong a litigant's case, is almost endless. But experienced litigants accept that, while there are such inherent risks in going to trial (and sometimes you lose as a result), overall the system tends to work. And, over time, justice will be done.

The problem for the auditing profession in a large-scale securities class action is that it simply cannot accept the inherent risk of losing at trial. The damages are just too high. And even if a firm decides to "bet the ranch" and take one potentially debilitating case to trial, it still has to deal with the next one. And then the one after that. At one point or another, the firm will inevitably lose. And that may be the end of the firm.

It is not that anyone really set out to fashion the law with this result in mind. It is, rather, a byproduct of the historical growth in public company market capitalization, the expansion of our securities laws, and the resulting level of damages that may be at issue.

All of this is exacerbated by the highly theoretical means by which securities law damages are estimated. The unfortunate fact here is that the damages models are extremely complicated, based largely on surmise and speculation presented in the jargon of theoretical mathematics, and often involve potential ranges of hundreds of millions or billions of dollars. While I have great faith in juries to address complicated matters as a general proposition, when it comes to damages models, the analysis is often way beyond the ken of anyone but the experts. For my part, I have personally sat through conflicting expert damages testimony convinced that no one but the experts themselves – not the judge, the jury, or even the lawyers – actually understood what was going on. An understandable reaction by the jury – which doesn't get to the issue of damages until it has determined that the defendant is in the wrong – is to simply throw up its hands and accept the plaintiffs' number. Making things still worse, an audit firm is often the only defendant left, or the one with the deepest pocket, so that it must absorb financial responsibility for the conduct of everyone, resulting in damages that are not only staggering but entirely disproportionate to the audit firm's comparatively limited role.

Faced with these kinds of risks, the prospect of an audit firm going to trial in a large-scale securities class action is almost always unacceptable regardless of the strength of its case. At present, I understand the six largest firms are facing claims amounting to more than $140 billion. A single case illustrates the resulting dilemma. A while ago, I was called upon to defend a securities class action against an audit firm in which the plaintiffs' estimated damages were $12.5 billion. The firm had a pretty strong case and assigned a likelihood of success of 90%. The problem was that a 10% chance of loss translated into an expected outcome of negative $1.25 billion. Based even on a 90% likelihood of victory, the predicted result was the bankruptcy of the firm

The irony in all this, moreover, is that, if it could accept the risk of presenting its case at trial, the profession might do just fine. For example, the first class action to go to trial under the securities law revisions of the mid-1990s was in many respects a classic case. There had been a fraud at a public company. The auditors had been given forged documentation. And the auditors had missed the fraud. The whole episode was presented over a four-week trial to a jury. Having heard all the evidence, the jury rendered its verdict for the defense and exonerated the audit firm's work. It was a rare instance in which an audit firm could take advantage of its "due process" right to go to trial.

Why could the firm take advantage of that right? The plaintiffs' estimated damages were only $32 million. If things went badly, the firm could have survived the loss. Had the estimated damages been in a higher range, the case probably would have ended like innumerable others. The audit firm would have settled.

And one of the big problems with this need to settle cases is that the plaintiffs' bar is very much aware of it. A consequence is a complete lack of credibility on the audit profession's part when it tries to argue it will defend itself to the end. Thus, ringing hollow is an audit firm's threat that it will "take the case to trial," which often has no credibility whatsoever.

The result is a lack of traction in settlement negotiations and higher settlement amounts. Defense costs, which themselves often amount to millions of dollars, are normally viewed as the floor for any negotiated resolution.

I hasten to add that this is not uniquely a problem for the accounting profession. A public company in a securities class action faces basically the same problems and risks. The key difference is that a public company may only have to go through the class action experience once or, if it is really unlucky, twice. The audit firms, in contrast, have to face these class actions non-stop. In a sense, the firms that audit public company financial statements are at risk for the entirety of their clients' market capitalizations.

There are some plaintiff lawyers, of course, who will make the case that they have no interest in bankrupting the auditing profession, or even one of the firms, for to do so would be to "kill the goose that lays the golden egg." According to this line of thinking, the risks to audit firm sustainability are exaggerated.

I have several reactions. Foremost, I have spent more than 25 years litigating against plaintiffs' lawyers. I'm sure I will be forgiven if I do not accept at face value their "trust me" approach. My own experience is that they want as much money as they can get and, if that results in the bankruptcy of a firm, so be it. Certainly that is the message they convey in settlement discussions.

A second reaction is, aside from whether the plaintiffs' lawyers are genuinely interested in the survival of the audit firm so they can sue it again, they have very little concept of how much cash can be extracted while leaving the firm viable. Nor can they control the amount of money that the litigation system will extract. The key point here is that, in the aftermath of a business reversal or failure, there may be claims by innumerable plaintiffs – shareholders, outside investors, lenders, derivative plaintiffs, a bankruptcy trustee, plaintiffs in state court, others. All of their lawyers will be in competition for the same finite pool of the audit firm's cash.

It is not the case, therefore, that a single plaintiff's lawyer can carefully calibrate precisely how much cash can be extracted from the firm and see to it that the firm pays exactly that amount. The reality is that a single plaintiff does not control the recoveries. An audit firm could pay to one plaintiff all it can afford only to be faced with a long line of additional lawyers making similar demands. That is pretty much what happened to Laventhol & Horwath when litigation helped drive it into bankruptcy in 1990.

I understand that a separate issue has been raised involving the effect of damages on audit quality. The thinking here is that the risk of debilitating damages motivates the firm to do better audits. A corresponding concern is that a reduction in the exposure to damages may lead to a deterioration in audit quality.

For my part, it is far from clear that is correct. The reason is that an audit firm cannot really control its exposure to litigation by doing better audits. The firm's susceptibility to litigation, rather, has much more to do with what happens to the audit client's business than audit quality. Indeed, at the time the audit firm gets sued, the plaintiff ordinarily doesn't even know the quality of the audit because the lawyers haven't seen the audit workpapers.

For an audit firm, therefore, the most effective way to manage risk is not through audit quality but through client selectivity. For that reason, in the wake of Enron it was completely unsurprising to me to see the largest and most sophisticated firms jettisoning higher-risk clients. An unfortunate consequence of this approach, of course, is that those public companies most in need of robust and sophisticated audits end up least capable of getting them. But our litigation system leaves the audit firms little choice.

Another issue that has arisen, I understand, is the issue of audit firm transparency. The suggestion is that capital markets are better served through increased transparency into the audit profession's finances.

I am not in the best position to evaluate the benefits to capital markets of increased firm transparency. I do, though, want to mention one downside. That is the foreseeability, if not likelihood, of the use of enhanced financial information against the firm in litigation. I know from my own experience that plaintiffs' lawyers can be intensely interested in an audit firm's ability to pay, particularly when their theoretical damages reach into the hundreds of millions or billions of dollars. As a general rule, the more there is, the more they want. So, in balancing the benefits and costs of increased transparency, we should understand that increased transparency may result in increased settlement demands. In the absence of a credible threat of going to trial (see above), that can translate into increased settlement payments.

In the search for solutions, one question posed is whether the risk to the firms might be addressed through an expansion of federal jurisdiction and a more refined definition of the standard of care. But I'm afraid I do not believe either would address the core problem. The cases to which I'm referring are already in federal court where the standard of care is already well defined.

I would like to address one final point on this topic which, I believe, will be of increasing importance as financial markets continue to globalize. That is the impact of our United States liability system on the quality of audits worldwide.

The context involves an apparent recognition that audit quality on a worldwide basis may be enhanced through an evolution beyond the present structure of global "networks" comprised of cooperating country-specific partnerships into more seamlessly integrated global organizations. Recent reports have thus described the consolidation of some of the KPMG European firms into "KPMG Europe." On a broader scale, a number of Ernst & Young network firms are reportedly seeking greater integration through more centralized structures. Foreseeably, an optimum structure would involve global audit firms with enhanced and more uniform audit quality.

It is almost inevitable, though, that one country would get left out of such a global consolidation: the United States. No sensible global firm would want to admit into the global partnership a United States audit firm when doing so would expose the firm's worldwide assets to United States-style class action litigation and damages. The need to exclude the U.S. firms would be unfortunate, for complete integration of U.S. firm expertise into a global firm would almost certainly serve to enhance audit quality and uniformity worldwide.

I for one, accordingly, do not accept at face value the proposition that the risk of debilitating liability has a positive impact on audit quality. At best, the litigation risk cuts both ways. I do, though, have a first-hand appreciation for the core problem in large-scale securities class action litigation: The audit firms cannot take the risk of presenting their case at trial. It is difficult to fathom a sensible solution unless that core problem is addressed.

I reiterate my thanks to the Chairmen and to the Committee for the invitation to make this submission.

May 23, 2008

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