

**Enron's Banks Escape Liability: Reconsidering the Accounting Profession's Opposition to Private Party Litigation to Prevent Third-Parties from Assisting in Fraud**

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Enron shareholders have recovered only a small fraction of their losses from the sudden demise of the company in 2001 and the company's resulting bankruptcy. The Securities and Exchange Commission (SEC) obtained only \$440 million for Enron shareholders (Former SEC Commissioners 2007), under the fair funds provision created by Sarbanes-Oxley Act (§ 308(a)). Enron shareholders have recovered about \$8 billion through private party settlements under the threat of litigation, mostly from investment banks engaged in fraudulent schemes with Enron (Rugaber 2007). Additional recovery is unlikely because Enron shareholders had relied upon the scheme liability doctrine to pursue their class action private litigation against the remaining banks which did not settle. In 2008, the Supreme Court rejected the "scheme liability" doctrine (*Stoneridge Investment Partners v. Scientific America*). Thus, Enron's shareholders can no longer hold investment banks accountable for engaging in a fraudulent scheme, even those which participated in proven criminal activity.

The accounting profession had three fundamental options to pursue in response to the Enron shareholder litigation against the investment banks: (1) silence, (2) opposing the investors, or (3) supporting the investors. Typically, the profession remains silent about litigation not directly involving the accounting industry. In *Stoneridge*, however, the accounting profession through the American Institute of CPAs (AICPA) openly opposed the investors' efforts to hold third parties accountable for engaging in a fraudulent scheme. A more appropriate option for

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upholding the integrity of the accounting profession would have the AICPA denounce any fraud and support the Enron shareholders who suffered from the fraudulent financial schemes in which some banks participated. The accounting profession's ethics were tested by the *Stoneridge* litigation and the profession placed its seeming self-interest above acquiring accountability for fraud by third parties.

### **Enron and the Role of its Investment Banks**

The SEC accused various investment banks of possessing knowledge that Enron was engaging in seemingly irrational transactions to create the illusion of accounting revenues and profits. Strong evidence existed that banks created and participated in financial transactions designed to deceive readers about Enron's balance sheet and income statement. The banks assisting Enron often used triangular deals where Enron had a transaction with a shell corporation which had a transaction with the bank (Reynolds 2004). The bank loans to Enron were effectively disguised as commodity transactions which enabled Enron to report non-existent earnings by using off-the-books partnerships to hide losses. The banks also underwrote new issuances of Enron stock, traded Enron credit default derivatives, and issued analysts reports on Enron (Lead Plaintiff 2007, 11). Thus, the banks were intertwined with Enron's corporate financing activities and effectively operated as constructive insiders.

In 2007, Enron shareholders lost their battle in a 2–1 decision in the Fifth Circuit against investment banks (*Regents of the University of California v. Credit Suisse First Boston*). The Fifth Circuit held that the investment banks did not have any fiduciary duty to Enron shareholders. Therefore, Enron shareholders could not proceed with a securities class action lawsuit against the investment banks. The Fifth Circuit in *Regents* concluded those who actually

employed the scheme were primarily liable for fraud, while third-parties such as investment banks who merely participated in the scheme were secondary violators of fraud and, therefore, not liable. Thus, third-parties had primary liability for fraud only when creating a document containing a misrepresentation that investors might rely upon. Ironically, the Fifth Circuit recognized the investment banks had knowledge of why Enron was engaging in the seemingly irrational transactions in order to create the illusion of revenues and helped the executives to maintain that illusion. The court concluded the banks only aided and abetted Enron's fraud by engaging in transactions to make the deception more plausible and could escape liability to the investors. On January 22, 2008, the Supreme Court formally denied Enron shareholders' request to review the Fifth Circuit's decision.

The auditing profession faces a "catastrophic litigation threat," according to the AICPA's affiliate organization, The Center for Audit Quality. Furthermore, it believes the massive litigation exposure is unrelated to auditor misconduct (Fornelli, 2008). The AICPA's serious concern about the litigation threat has led the AICPA to comment on Supreme Court cases addressing third-party liability cases, even those cases not involving auditors.

### **AICPA's POSITION ON FIGHTING FRAUD**

The AICPA supports fighting fraud when auditors' liability is not an issue. Consideration of fraud is part of the audit process in assessing an organization's fraud risk (AICPA 2008, AU § 316). The expectation gap between auditors work and investors expectations has pressured the profession to take more action in recognizing fraud.

When auditors' liability becomes an issue, however, the AICPA has opposed investors who seek accountability from third parties involved in fraud. In an *amicus curiae* brief, a

position statement filed in court by an interested third party, the AICPA in *Stoneridge* warned of the extreme case if “auditors face the prospect of bet-the-firm litigation based on a peripheral connection to statements they have made and transactions they have not audited.” (Nilsen 2008). The AICPA’s brief expressed concern about potential liability for services other than audits, such as quarterly reviews (2007, 18), because even after *Stoneridge*, auditors have potential primary liability if participating in any fraudulent activity related to audited financial statements. Yet, the AICPA notes that “since *Central Bank*, courts have consistently rejected attempts by class action counsel to sue auditors on the basis of alleged misstatements in their clients’ unaudited quarterly filings” (2007, 19). Some auditors fear that a court might reclassify auditing negligence as participating in a fraudulent scheme and create extensive liability for the auditors.

Scheme liability was a doctrine that extended liability to all parties participating in a fraudulent scheme. Thus, scheme liability could apply to those auditors whose actions actually participated in the fraudulent scheme. Opponents of scheme liability for fraud, such as the AICPA, feared if the Supreme Court accepted the scheme liability doctrine, the number of shareholder class action lawsuits would explode. They argued the doctrine would expand the field of class action securities lawsuits (Scannell 2007a). Their belief is that accountants are attractive deep-pockets for securities fraud litigation, especially since about one-third of the securities fraud cases against auditors involve companies in bankruptcy (AICPA 2007, 23, citing Palmorose 1997). The AICPA’s belief is a realistic concern because “accounting related cases represented over 60 percent of all private securities class actions” (PWC 2007, 36). After the PSLRA of 1995, however, auditors are included in less than 20% of all settlements, suggesting that often the auditors have no liability. Auditors are typically included in cases settling for the higher amounts (Simmons and Ryan 2008, 8).

Those opposing liability for third-party fraudsters have also argued that the scheme liability doctrine places U.S. capital markets at competitive disadvantage with excessive litigation costs. Similarly, the Bush administration represented by Solicitor General Paul Clement feared the scheme liability doctrine would hamper business transactions with frivolous lawsuits (Barnes and Johnson 2008, D1). Their position also expressed concern about potentially creating potential liability for parties far removed from the financial markets.

## **SECURITIES LAW ON FRAUD FOR THIRD PARTIES**

Securities law on fraud for third parties consists primarily of Section 10(b) of the Securities Act of 1934 and Supreme Court cases. The two most important cases on third-party liability for fraud are the Supreme Court's 1984 decision in *Central Bank of Denver v. First Interstate Bank of Denver*, and the Court's 2008 decision in *Stoneridge*. This section discusses this essential legal background to enable a more in-depth analysis of the implications for auditors and the accounting profession.

### **Liability for Fraud under Section 10(b) and SEC's Rule 10b-5**

The 1934 Act provided the SEC with broad powers to combat securities fraud, especially under Section 10(b), which is the basis for most securities fraud litigation (Thel 1990). Section 10(b) prohibits any person from directly or indirectly using “*any manipulative or deceptive device or contrivance*” in connection with the purchase or sale of securities if it violates any SEC rules. Prohibition of a scheme to deceive is found in the meaning of both a prohibited *device* and *contrivance* (*Ernst & Ernst v. Hochfelder*). *Manipulative* conduct refers to actions to mislead investors by artificially affecting market activity (*Santa Fe Industries v. Green*). *Deceptive*

conduct involves either a misstatement or a failure to disclose by one having a duty to disclose (*Simpson v. AOL Time Warner*).

The SEC's Rule 10b-5 essentially interprets the "any manipulative or deceptive" conduct language of Section 10(b). Rule 10b-5 gives meaning to the prohibited conduct with alternative types of deception identified in the three subsections of Rule 10b-5. Historically, third-parties as aiders or abettors to fraud were found liable under Section 10(b) only via subsection (b) of SEC Rule 10b-5, which prohibits a material misstatement or omission (*In Re Parmalat*). However, Section 10(b) liability may occur by a scheme to defraud as in SEC Rule 10b-5 subsections (a) or (c), without any misstatement or omission (*SEC v. Zandford*). Subsection (a) of SEC Rule 10b-5 prohibits using "any device, scheme, or artifice to defraud." Subsection (c) prohibits engaging in a practice which would operate as fraud.

Liability under Section 10(b) and SEC Rule 10b-5 requires the common law elements of fraud: scienter, materiality, reliance, causation, and damages. Thus, the defendant must have used non-public information to engage in fraudulent conduct or made an untrue statement or omission of material fact, with "scienter," a mental state consistent with the intent to deceive, manipulate, or defraud (*Ernst & Ernst v. Hochfelder*). The improper conduct must have occurred in connection with the purchase or sale of securities. Furthermore, the plaintiff must have relied on the misrepresentation and sustained damages as a proximate result of the misrepresentation (*Dura Pharmaceuticals v. Brude*). The Court has explained that Section "10(b) and Rule 10b-5 prohibit *all* fraudulent crimes in connection with the sale or purchase of securities ..." (*Superintendent of Insurance v. Bankers Life & Casualty*).

In the mid-1990s, the accounting profession was alarmed about the explosion of securities litigation conducted through large class action lawsuits, frivolous lawsuits, and the

high costs for defending their professional work in the legal system (Palmrose 1994). Accounting firms are frequently targeted third parties for securities fraud because auditors provide reasonable assurance about a company's financial statements. In 1995, after extensive political effort by the accounting profession (Roberts, Dwyer, and Sweeny 2003), Congress addressed these concerns in the Private Securities Litigation Reform Act (PSLRA) (*Tellabs v. Makor*). PSLRA raised the standard for any court to accept a securities class action primarily by tightening the pleading standards for "scienter" to have a state of mind giving rise to "a strong inference" that the securities laws were violated (Mark 2007). Also, liability exposure was reduced for the accounting profession through a system of proportional liability, liability limits, clearer professional responsibility to conduct audit procedures to help detect illegal acts (King and Schwartz 1997).

After the PSLRA, court dismissal of securities class action lawsuits doubled. The Big Six accounting firms became less conservative in their audits, as shown by a lower propensity to issue going concern opinions (Geiger, Raghunandan and Rama 2006, 349). Lee and Mande (2003) examined discretionary accruals and also found that the Big Six accounting firms were less conservative following enactment of PSLRA.

### ***Central Bank of Denver in 1994 Precludes Secondary Liability***

In *Central Bank of Denver v. First Interstate Bank of Denver*, the Supreme Court in a 5–4 decision effectively relaxed potential liability for third-parties by eliminating secondary liability from aiding and abetting fraud. Previously, the aiding and abetting fraud cause of action was the easiest way for private parties to hold third-parties liable for participating in securities fraud

(Nowicki 2004, 710–711). Therefore, rarely did private parties seek to hold third-parties primarily liable.

Third-party liability for aiding and abetting fraud was recognized by all of the circuit courts of appeal prior to the Supreme Court’s 1994 decision in *Central Bank of Denver* (Kuehnle 1988–1989). The Court held that Section 10(b) did not authorize a form of secondary liability for fraud by third parties. However, the Court hinted that other parts of the securities law could hold third-parties liable for securities fraud.

Before 1994, a third-party was “an aider or abettor of federal securities law violations if a client violated the federal securities law (a primary violation under Section 10(b)), the third-party knew (or was reckless as to the existence of) the primary violation, and the third-party provided substantial assistance to the wrongdoer in accomplishing the primary securities violation (*First Interstate Bank of Denver v. Pring*). Hundreds of aiding and abetting cases were brought against third-parties who aided and abetted the primary violator of Section 10(b). Third-parties were often only tangentially involved in alleged fraud, but they were a popular target as a potential deep pocket of funds to compensate the victims of fraud (Concannon 1994-1995). All Circuit Courts of Appeal had accepted the legal concept of aiding and abetting fraud liability under Section 10(b) and Rule 10b-5 (*Central Bank of Denver*). Aiding and abetting fraud liability had encouraged third-parties to maintain a higher level of professionalism.

The Court’s analysis in *Central Bank of Denver* strictly interpreted the statutory language of Section 10(b). The Court noted that Section 10(b) did not include the words “aid” or “abet.” A third-party as a secondary party is still liable as a primary violator of fraud under Section 10(b) and Rule 10b-5 if all requirements for primary liability exist. Thus, *Central Bank of Denver*

foreclosed liability for aiding and abetting fraud, but left undecided the full scope of misconduct creating primary liability for third-party fraud.

The dissent in *Central Bank of Denver* criticized the majority's decision on several dimensions. One major criticism was that the majority failed to recognize Congressional intent was apparent in prior legislation with an approving reference to liability for aiding and abetting fraud. The dissent was reluctant to restrict the legal rights of private parties enforcing securities laws which courts have recognized for decades.

The shocking *Central Bank of Denver* decision overturned a generation of precedent that enabled shareholders to sue aiders and abettors of securities fraud. *Central Bank* adopted a narrow textual analysis in defining Section 10(b)'s scope, rather than examining the definition of the key terms in the statute. In essence, the Court disregarded precedent, legislative intent, and public policy for its interpretation. However, Langevoort (1995, 891–892) accurately predicted that the federal courts would recast the scope of primary liability for fraud to help reestablish balance in securities fraud litigation.

### **Liability for Few Third-Parties After *Central Bank of Denver***

The year after the *Central Bank of Denver* decision, Congress overturned part of the result from the case by permitting the SEC to proceed against third-parties who aided and abetted a company's securities fraud (PSLRA § 104(f)). However, the PSLRA did not change the primary decision in *Central Bank of Denver* to prohibit lawsuits based on aiding and abetting fraud by private shareholders.

As a result of *Central Bank of Denver*, legal accountability was substantially reduced for third-parties who departed from professional standards and expectations. Class action lawsuits

initially fell significantly after PSLRA (SEC 1997). However, each of the major international accounting firms has pending litigation with legal claims that could bankrupt the firm (Nusbaum 2007, C6). Other significant effects from the *Central Bank of Denver* decision included less potential recovery for defrauded investors and a greater strain on overburdened SEC resources.

After *Central Bank*, several cases extended Section 10(b) liability to third-parties using different theories of primary liability (Prentice 1996-1997, 700–702). In 2002, the Supreme Court considered third-party liability under Section 10(b) in *SEC v. Zandford*. The Court in *Zandford* held that a stockbroker violated Section 10(b) and Rule 10b-5 when he sold his customer's securities and unlawfully kept the proceeds, even though the stockbroker made no affirmative misrepresentation. In *Zandford*, the securities sale and the fraudulent conduct of third-parties were linked. The Court noted that it must construe Section 10(b) flexibly to achieve its remedial purposes to eliminate securities fraud. The fraudulent scheme in *Zandford* did not require a misstatement by the third-party to trigger liability.

Whether a bank was primarily liable for a corporate client's fraud under Section 10(b) arose in *In Re Parmalat*. Parmalat falsely represented on its financial statements that the company had sizeable cash balances, but almost \$5 billion of cash was nonexistent and \$16 billion of debt was not disclosed (Gallani 2004). The bank argued that it merely structured a transaction that its client Parmalat misrepresented. At worst, the bank was just an aider or abettor of Parmalat's fraud and therefore, not liable for securities fraud after *Central Bank of Denver*. The *In Re Parmalat* court noted that courts have not always distinguished clearly between primary violators of fraud under Section 10(b) and third-parties who were merely aiding and abetting the fraud. The court insightfully noted that previously most courts failed to focus on the distinction between the types of prohibited conduct in subsections (a) and (c) of Rule

10(b)-5. Thus, the *In Re Parmalat* court noted that until a third-party creates a sham business or deceptive transaction, a primary violation of Section 10(b) will not exist. A third-party's deceptive conduct intended to inflate a stock price was sufficient to establish primary liability for fraud under Section 10(b). Thus, through careful reading of Section 10(b) in *In Re Parmalat* the court found that third-parties such as auditors could have primary liability through substantial participation in the client's fraudulent scheme.

### **Scheme Liability Made More Third-Parties More Accountable for Fraud**

The scheme liability theory is based on the belief that Section 10(b) prohibits any device to defraud. The Supreme Court has previously defined a "device" to include a scheme (*Ernst & Ernst* 1976). Although subsections (a) and (c) of the SEC's Rule 10(b)-5 explicitly prohibit any scheme to defraud, that language is not explicit in Section 10(b)'s prohibition of any practice to defraud. However, the Supreme Court has several times adopted the SEC's position and prior to 2008, reiterated that Section 10(b) prohibits a scheme to defraud (*SEC v. Zandford*).

Under the scheme liability theory, when a third-party knowingly engages in a primary violation of federal securities law in furtherance of the fraudulent scheme, the third-party is partly and severally liable for the loss caused by the scheme. Different courts have had various formulations of this scheme liability doctrine (Markel and Ballard 2006). Scheme liability occurs in only a small fraction of the securities cases, although they are usually the largest class action cases (Rummeli 2007).

In 2006, the scheme liability doctrine was accepted by the Ninth Circuit (*Simpson v. AOL*). The Ninth Circuit considered what type of conduct was manipulative or deceptive in furtherance of a scheme in *Simpson v. AOL*. In an *amicus curiae* brief the SEC argued that any

person who engages in a manipulation or deceptive act as part of a scheme to defraud could qualify as a primary violator of Section 10(b) and Rule 10b-5. The Ninth Circuit found the plaintiffs had failed to plead adequately how the defendants were primary violators of Section 10(b) based on their role in furtherance of a financial fraud scheme. The Ninth Circuit held that it is not enough for the transaction with the third party itself to have a deceptive purpose. Rather, the third party's own conduct must have a deceptive purpose for a court to hold a defendant guilty of a scheme to defraud. Conduct consistent with the normal course of business does not recreate a misrepresentation (*SEC v. Zandford*).

### **Supreme Court Rejects Scheme Liability in *Stoneridge***

In *Stoneridge* the shareholders in Charter Communications brought a class action lawsuit against two of Charter's largest business partner suppliers. Charter as a cable provider agreed to pay its suppliers an additional \$20 per cable box in a sham transaction, in exchange for an equal added payment to Charter as advertising fees at a price almost five times normal advertising rates. The shareholders alleged the added \$20 charge falsely inflated Charter's cash flow by about \$17 million in the final quarter of the year, enabled Charter to inflate its forecasted revenues, and increased its stock price. Thus, the shareholders argued in court that the suppliers deceived Charter's shareholders under Section 10(b) because the sham transactions artificially boosted Charter's revenues; the suppliers knew that Charter intended to account for the transactions improperly by capitalizing the advertising expenses. Furthermore, to create an appearance of legitimacy, the suppliers issued false documentation as to the price increases because of higher costs, and falsely backdated contracts.

Given the split among the circuit courts of appeal on the scheme liability theory, the Supreme Court in *StoneRidge* considered whether shareholders may hold third-parties liable for fraud under Section 10(b) using a “scheme liability” theory. The Eighth Circuit in *Stoneridge* relied on *Central Bank of Denver* to dismiss the plaintiff’s claims. The Eighth Circuit held that scheme liability does not create deceptive conduct for primary liability under Section 10(b). Third parties were intensely interested in the *Stoneridge* case. Thirty *amicus curiae* briefs were filed with high profile support for both the investors and the businesses opposing them. Opposing the investors were not only the AICPA, and also the U.S. Chamber of Commerce, several stock exchanges, and various law firms representing big business.

In January 2008, the Supreme Court ruled against scheme liability in a 5–3 decision in *StoneRidge*. The majority opinion noted that scheme liability was not differentiable from the discarded aiding and abetting fraud theory of securities liability that *Central Bank of Denver* prohibited. The Supreme Court stated the banks’ actions presented “an indirect chain of causation” that was too remote for liability. The Court expressed concern that scheme liability could raise the cost for public company status and discourage securities offerings in the United States.

Justice Stevens in the dissenting opinion in *Stoneridge* noted that private party lawsuits help to insure investor faith in the capital markets. The dissent also suggested a meaningful distinction existed between the two theories. Thus, the court could hold at least some third-party accountable for fraud by applying the scheme liability doctrine under Section 10(b). The dissent noted that the majority should have distinguished between legitimate business transactions in *Central Bank of Denver* and the sham transactions in *Stoneridge* having no substantial business purpose.

The Supreme Court erred in assuming that the scheme liability doctrine would open a floodgate of frivolous litigation, because other reforms made in 1995 in PSLRA helped to reduce nuisance litigation against third-parties. In recent years, in several securities law decisions the Court has shown an anti-investor sentiment.

## **IMPLICATIONS FOR THE ACCOUNTING PROFESSION**

The legal environment affects the accounting profession's behavior (Geiger and Raghunandan 2002). Although a tradeoff exists between the costs and benefits of holding third party fraudsters accountable for fraud, the accounting profession needs to have the ethical backbone to support holding all third parties liable for participating in fraudulent schemes, including any improperly acting parties within its own profession. Legal deterrence is needed to maintain quality audits (Treasury Department 2008, 44,344). The need for legal deterrence increased in the 1990s with PSLRA and as auditing structures changed from partnerships to limited liability entities (Cunningham 2007).

While the accounting profession should seek reasonable legal protection, it is unrealistic for the accounting profession to expect complete immunity from the law if the accountants or auditors contribute to fraud. "The audit community's desire for legal immunity ... will continue to put the audit profession in the position of having to decide whether fundamentally it wants to align itself with investor or preparer interests" (Silvers 2007, 442). Realigning with investor interests should cause the profession to rethink its position opposing legal accountability for any third party that participates in a fraudulent scheme. "Limiting auditor liability would reduce audit firm accountability, provide a significant market incentive to take audit shortcuts, and reduce overall audit quality to the detriment of investors" (ICGN 2008). Thus, more negligence in

auditing is expected from auditors if they do not have to worry about liability from participating in a fraudulent scheme.

Major investors represented by pension plans filed *amicus curiae* briefs which supported scheme liability. They believe that the Supreme Court's failure to endorse the scheme liability doctrine issued a green light for outsourcing fraudulent deceptive acts to third-parties who the courts will not hold accountable. Further support for the investors position in *Stoneridge* was shown by a majority of state attorneys general, various Congressional leaders, and a group of former SEC commissioners. The *amicus curiae* brief in *Stoneridge* filed by the former SEC Commissioners (2007) explained the importance of the scheme liability doctrine for "continued deterrence of fraud, the ability of defrauded investors to recover their losses, and the overall fairness and effectiveness of our securities markets." The Enron shareholders had asked the SEC to support private party liability for third-parties engaged in a fraudulent scheme (Diamond 2007). The SEC in a rare three to two vote recommended that the U.S. Solicitor General's Office support the investors' position and permit them to file private lawsuits against Enron's banks (Scannell 2007b).

"The overly litigious culture results in financial reporting designed as much to protect against liability, as to inform investors," according to the SEC's Advisory Committee on Improvements to Financial Reporting (2008, 14). The SEC's Advisory Committee advocated that investor perspectives must become paramount for the financial reporting process (2008, 38). An educational initiative to clarify the auditor's role detecting fraud was proposed by the Treasury Department's Advisory Committee on the Auditing Profession (2008). An educational initiative, however, does not satisfy the public's expectation for any third parties not to assist in perpetuating a fraud

Bankers, attorneys, auditors who act as client's business advisers, and other third parties may play a crucial role in structuring and completing today's business transactions, as well as accounting and reporting the completed transactions. The concern is whether the advisers have used techniques illegally designed to mislead users of a company's financial statements. The complexity and size of many business transactions in the global economic environment of the 21<sup>st</sup> century often requires assistance from specialized third parties. Third-parties may have the ability to stop a fraudulent scheme by withholding support to help prevent the primary party from engaging in securities fraud (Kraakimin 1986). Private parties have an enormous stake in preserving the integrity of their investments. These lawsuits have helped investors recover substantially more funds than mere reliance on the SEC to take action to assist the defrauded investors. For example, in Worldcom, while the SEC obtained \$750 million for investors, private parties through related class actions obtained \$6.2 billion, over eight times the SEC's recovery (Brief from Council of Institutional Investors 2007, 48–49).

In massive, scandalous corporate bankruptcies, such as in Enron, reputational incentives and existing legal penalties are shown to be inadequate to deter third-parties from assisting major clients who are engaging in securities fraud (Coffee 2001). Instead, third-parties often have a built-in financial incentive to advocate what their clients' desire (Prentice 2000, 1640).

Collusive fraud involving third parties is very difficult for auditors to detect. The auditing profession should do everything reasonably possible to discourage parties from engaging in fraud, including supporting legal accountability for all parties knowingly involved in fraudulent transactions. Yet, this was clearly not the position advocated by the AICPA before the Supreme Court.

Historically, “in its zeal to protect itself from liability, the profession has given every impression of attempting to avoid responsibility.” (Burton 1971, 49). With the failure of Enron and other major companies in the early 2000s, the accounting profession and society paid an enormous price for the failure to meet investors’ needs (Wyatt 2004). History may repeat itself in the future because the accounting profession, as shown by the AICPA’s *amicus curiae* brief in *Stoneridge*, abdicates its professional responsibility to help protect investors from third parties fraudsters. The *Enron* case against banks and the *Stoneridge* case against suppliers presented the accounting profession with an excellent opportunity to speak out against third-party assistance in fraud, but the profession’s leadership failed miserably. *Stoneridge* involved a third party who was not independent of management and provided assistance to the client in concealing a fraud, unlike auditors who must act independently (Laby 2006, 132). Supporting third party fraud discredits the accounting profession and the core values that the accounting profession should represent.

Accountants should take little comfort in the *Stoneridge* decision because courts will still find auditors of public companies liable under Section 10(b), because the audited statements are published in the SEC filings. The SEC has suggested primary liability when the principal “purpose and effect” is to deceive shareholders because the action qualifies as a deceptive act under Section 10(b). The AICPA brief expresses fear that under the “purpose and effect” test, inventive lawyers could easily extend Section 10(b) liability to auditors (AICPA 2007, 19).

The accounting profession must recognize that some litigation plays a valuable role in regulating audit quality and the integrity of financial reporting. Facing litigation makes auditors more resistant to client pressure (Shafer, et al 1999). “Tough [laws and their] enforcement is essential for a strong securities market since it ensures that wrongdoers are punished and

relinquish any benefits obtained by violations.” (Committee on Capital Markets Regulation 2006, 72). The accounting profession should support pressing other third parties to act responsibly and help maintain the integrity of the financial markets, especially given that combined auditors and the SEC discover only 20% of fraud cases (Dyck, Morse and Zingales 2007, 2). While the AICPA has issued more guidance in auditing for fraud (AICPA 2002), the accounting profession will not meet the high public expectations for auditors unless the profession pushes all third parties to have strong motivation in preventing fraud. It is not enough that the AICPA join with other organizations to issue guidance for management to prevent fraud (IIA, AICPA, and ACFE 2008).

In 2002, after high profile corporate fraud at Worldcom and Enron, a Republican Congress and president enacted the Sarbanes-Oxley Act (Sarbox 2002). Among its many effects, Sarbox strengthened auditors’ ability to conduct an independent audit, especially through rules to prohibit the improper influence on an audit (Sarbox § 303(a)). Under Sarbox penalties were established for financial fraud, white collar crime, and improper certification of financial statements (Sarbox § 906). Sarbox also set a tone for a tougher enforcement environment at the SEC (Mann and Barry 2005, 669). The accounting profession’s failure to oppose third party fraud consistently may invite a Democratic Congress or President to take another look at further regulating the accounting profession. Such action may lead Congress to reverse the Court’s holding in *Stoneridge* to enable private parties to hold third-parties liable for participating in a financial fraud scheme, as well as strengthen Sarbox with stronger potential civil and criminal penalties for any assistance in financial fraud.

## CONCLUSION

The Supreme Court in *Stoneridge* decided in a split decision to adopt the AICPA's position opposing legal accountability for third parties engaged in any fraudulent scheme. The Court's decision and the AICPA's position is likely to lead to disastrous use of more third parties in structuring or concealing fraudulent transactions.

The accounting profession should consistently speak loudly opposing fraud and lack of accountability for third parties who participate in a fraudulent scheme. The profession should feel an ethical responsibility to help investors and lead the fight against securities fraud. The profession is engaging in short term thinking when it seeks legal immunity for all third parties involved in a fraudulent scheme. Thus, the accounting profession should voice opposition to fraud, even when it might result in slightly higher potential legal liability for the profession. The profession should feel reassured that it continues to have substantial legal protection from the reforms created in 1995 in the PSLRA.

Financial fraud harms the public's faith in the integrity of the financial markets and the accounting profession. Fundamentally, the accounting profession should help assure that investors and the public can rely on audited financial statements. When accountants take the appropriate course of action, even when that result is not financially desired, it's a sign of professional courage (Thomsen 2007). Only through fundamental professional courage, such as accepting liability for third parties participating in a fraudulent financial scheme, will the accounting profession avoid heavier government regulation in the future.

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