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Accountants' Common Law Liability To Third Parties: Another Look

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NORTHERN ILLINOIS UNIVERSITY
Accountants' Common Law Liability
To Third Parties:
Another Look

A Thesis Submitted to the
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ABSTRACT:

Third-party litigation against public accountants has increased significantly during the past two decades. In response to this litigation explosion, the accounting profession has proposed reforms in the legislative and judicial aspects of the legal system. This paper presents an objective view of the litigation crisis facing the public accounting profession and some possible solutions.

The research included personal interviews, in addition to a review of current articles and the transcript of the Bily v. Arthur Young & Co. court verdict. Text book research provided the base for all other information.

The product liability theory, the expectation gap, accountants' common law liability to third parties, and theories regarding this liability are explained. Public accounting's Statement of Position and high risk audits are discussed. Potential solutions are then presented.

Reform for both the accountants and the legal system are necessary to avert a crisis in the accounting profession and for the public.

**Accountants' Common Law Liability
to Third Parties: Another Look**

Third-party litigation against public accountants has increased significantly during the past two decades. In response to this litigation explosion, the accounting profession has proposed reforms in the legislative and judicial aspects of the legal system. The purpose of this paper is twofold: to present an objective view of the litigation crisis facing the public accounting profession; and to discuss possible solutions.

The methodology utilized to gather information will be described in the next section. The surge of litigation, its impact on the accounting profession, and potential solutions to the legal liability crisis will also be discussed in depth. The conclusions of the author are presented in the final section of the paper.

Method

A review of the literature was conducted to gain a basic understanding of the legal liability issues affecting the public accounting profession. An interview questionnaire designed to elicit the opinions of legal experts regarding accountants' legal liability was developed (The questionnaire is presented in Appendix A.). Care was taken to address issues relevant to both accountants and third-party users of financial statements.

The three legal experts included in the study were Professor Harold Wright, Professor Samuel Oddi, and Attorney Howard Stone.

Professor Harold Wright is an Associate Dean in the College of Business at Northern Illinois University. Professor Wright directs the Executive MBA Program and teaches the business law sections of the Certified Public Accountant (CPA) review course. Samuel Oddi is a Professor in Northern Illinois University's College of Law. Professor Oddi specializes in professional liability issues. Mr. Howard Stone, CPA, Certified Fraud Examiner, is an attorney at Stone, McGuire & Benjamin. Mr Stone was the Co-chair of the Illinois CPA Foundation's Professional Liability Conference.

Professors Wright and Oddi were interviewed in person. Mr. Stone's interview was conducted in writing through the mail.

The Litigation Explosion

"The number of lawsuits filed annually in federal courts jumped from 86,000 to 239,000 between 1962 and 1982," and "more suits have been filed against accountants in the past 15 years (1972-1987) than in the entire previous history of the profession" (Mednick: 119). Several theories attempting to explain this escalation of litigation have emerged. Some experts theorize that accountants are finally being held accountable for a product they promised the public they could deliver--accurate information about a company's financial position. Others, including Professor Harry Wright, believe Americans in general want to be protected. They do not want to take responsibility when something "bad" happens and use the legal process to blame

other parties. In this case, third parties view accountants as their shield against losses from bad investments. These parties believe that an unqualified opinion on a company's financial statements means the company is financially sound. Thus, should a company receiving a clean opinion subsequently declare bankruptcy, there must have been an audit failure.

Another possible cause for increasing litigation is the amount of damages being awarded. In fact, "Justices Sandra Day O'Connor and John Paul Stevens have observed that punitive-damage awards are skyrocketing" (White: 2). It is very probable these recent large settlements and jury awards have encouraged questionable suits. Plaintiffs are hoping the threat of a possible large judgement will encourage a settlement.

Product Liability Theory

Traditionally, American society has chosen to protect the naive buyer from the unscrupulous seller. Manufacturers were considered more capable of protecting themselves through insurance than the consumer and, therefore, are held to a higher liability standard. The same "theory of strict product liability has been expanded by some courts to the area of professional liability" (Minow: 72).

The New Hampshire Supreme Court compared accountants and manufacturers to justify the broad, new liability: 'An accountant, like the manufacturer under products liability law, is in the best position to regulate the effects of his conduct by controlling the degree of care exercised during the performance of his professional duty. The accountant, through the fee structure, can pass along to his clients the

cost of insuring against financial loss sustained by them through reliance upon his negligent misstatement of fact'" (Minow: 77).

However, manufacturers and other opponents of product liability theory argue:

What if in our zeal to punish the reckless and the criminal and the negligent we drive too many companies into bankruptcy? Or what if the costs of such awards render American goods uncompetitive in international markets? How many jobs will be lost when companies export jobs to a less litigious environment? (White: 2).

Accountants' arguments against product liability theory include lower profit margins, increasing insurance costs, and shrinking liability coverage.

Expectation Gap

Third-party users of audited financial statements generally expect a product that is much different from what the auditor delivers. The accounting profession is partly to blame for this gap between expectation and reality. Professor Harry Wright believes the presentation of the financial statements themselves leads people to believe the numbers are "hard and cold" when, in fact, many account balances contain estimations that "are not as neat as they appear." Relevant information may be disclosed in footnote, but the face of the statements leave the misperception of complete accuracy.

Furthermore, after the Securities Act of 1933 and the Securities Exchange Act of 1934, the profession did little to

clarify for the public the degree of responsibility assumed, leading to these three expectations:

(1) Auditors perform the audit with technical competence, integrity, independence, and objectivity; (2) auditors search for and detect material misstatements, whether intentional or unintentional; and (3) auditors prevent the issuance of misleading financial statements (Kell: 87).

Additionally, auditors are now expected to address the going concern issue. Essentially the auditor must assess the likelihood of a business failure occurring within twelve months of the balance sheet date.

In an attempt to narrow the expectation gap, the American Institute of Certified Public Accountants (AICPA) issued nine new Statements on Auditing Standards (SASs). The standards have helped the auditor define what is expected of her. The abstract nature of the issues and the precise wording of the standards, however, make it difficult for the less-sophisticated financial statement user to fully understand the auditor's responsibility. This holds equally true for judges and juries. Twelve years ago Victor Earle, general counsel of Peat, Marwick, Mitchell & Co., described with precision this confusion:

The misconceptions in the public mind are at least five fold: first, as to scope -- that auditors make a 100 percent examination of the company's records, which can be depended upon to uncover all errors or misconduct; second, as to evaluation -- that auditors pass on the wisdom and legality of a company's multitudinous business decisions; third, as to precision -- that the numbers set forth in a company's audited financial statements are immutable absolutes; fourth, as to reducibility -- that the audited results of a company's operations for a year can be synthesized into a single number; and fifth, as to approval -- that by

expressing an opinion on a company's financial statement, the auditors 'certify' its health and attractiveness for investment purposes (Minow: 77).

The public's expectations clearly differ from the product accountants deliver. The public's expectations and the inability of accountants to meet these expectations has placed the credibility and reputation of the accounting profession in jeopardy.

Third-Party Liability Defined

Should a third party sue the CPA of audited financial statements, the basic elements that must be proved are "duty of care, the CPA's breach of that duty, damage suffered by the third party, and a sufficiently close causal connection between the CPA's breach and the third party's damage" (Miller, GAAS: 112.02). The duty of care element has three standards: ordinary negligence, gross negligence or recklessness, and fraud. Any one of these standards, or any combination thereof, may be used in an action against the CPA.

Ordinary negligence occurs when the CPA fails to perform an audit with due professional care and is relatively easy to prove. In some cases, a bad decision or an error in judgment may be interpreted as ordinary negligence. For example, an auditor may decide, based on her judgement of the situation, not to perform a particular audit procedure. If this procedure would have uncovered fraudulent activities on the part of the client, third-

party investors might argue that the auditor was negligent for not performing that procedure.

Gross negligence is defined as a serious occurrence of negligence. Recklessness, although similar to gross negligence, involves cases in which reasonable steps were not taken to assure reliability of the financial statements being audited.

Recklessness is sometimes called constructive fraud. Fraud, the third standard for the duty of care element, "occurs when a CPA issues a report on financial statements knowing that the financial statements are false" (Miller, GAAS: 112.04).

If an accountant is found liable, she may be required to bear 100 percent of the damages even if she is only 20 percent at fault. This concept of joint and several liability protects plaintiffs against losses by allowing them to collect from any defendant. The entire judgement can be collected from one defendant, leaving per-share issues for the co-defendants to sort out. The "deep pocket" accountants are usually the easiest to collect from. Although the accountants have a right to indemnification from the other defendants, co-defendants are often unable to pay their share. Therefore, the accountant is exposed to risk far beyond the amount of audit fees.

Theories on Third-Party Liability

To date, there are four legal theories of accountants legal liability to third parties for ordinary negligence. (Note: auditors are generally liable to all third parties for gross

negligence or fraud.) The first view, which is nearly extinct, makes it very difficult for third parties to bring suit against an accountant. This view maintains that an accountant has no liability without privity. Privity occurs only under a contractual relationship. The second view is the same except that it broadens privity to its practical equivalent. Three prerequisites now required to prove practical equivalency of privity are:

(1) the auditor was aware that the financial statements were to be used for a 'particular purpose,' (2) the auditor knew that, in furtherance of this 'particular purpose,' it was intended that the plaintiff rely on the financial statements; and (3) the auditor engaged in some conduct, linking the auditor to the plaintiff, and showing the auditor's understanding that the plaintiff would rely on the financial statements (Miller, GAAS: 112.05).

Expanded liability beyond the privity relationship was originally announced in *Ultramares v. Touche, Niven & Co.* by New York's highest court in 1931. However, because of these three requirements and the undefined meaning of "particular purpose," third parties still have difficulty pursuing cases in states adopting this view.

A third approach (the Restatement approach) expands the CPA's liability for ordinary negligence to include a limited group of third parties (foreseen third parties) for whose benefit the CPA's work is supplied. The first case promulgating the Restatement approach was *Rusch Factors, Inc. v. Levin* (1968) in Rhode Island's Federal District Court.

The fourth and final view, emerged in 1983 when the New Jersey court in *H. Rosenblum, Inc. v. Alder* held "that an auditor who commits ordinary negligence will be held liable to third parties whose reliance was reasonably foreseeable, unless consideration of public policy makes this result inappropriate" (Miller, GAAS: 112.08). Wisconsin issued a similar decision in 1983. Under the reasonably foreseeable view, the actually foreseen and the limited classes do not have to be proved. "The plaintiff need only demonstrate that the reliance on the CPA was reasonably foreseeable by the CPA at the time of the audit, that public policy would be served by holding the CPA liable, and that the CPA committed ordinary negligence, on which the plaintiff relied to his or her detriment" (Miller, GAAS: 112.08). These public policy issues are decided on a case-by-case basis. This view is by far the most liberal, raising accountants' liability risk substantially.

A fifth possible view has recently come forth. The fraud on the market theory would expand CPAs' liability to individuals who never saw the audit reports (i.e., persons who relied on investment publications based on audit reports). To date, no court has upheld this standard. The unlimited liability of the fraud on the market theory is what Judge Cardozo, in *Ultramares v. Touche, Niven & Co.* feared in 1931. Cardozo felt "that accountants could not be held liable to third parties for negligence because it might 'expose accountants to a liability in

an indeterminate amount for an indeterminate time to an indeterminate class'" (Minow: 76).

Although common-law liability is broadening, there is some statutory relief available for accountants. Because of the different common law views, some states have enacted legislation to clarify their position on CPAs' liability to third parties. Illinois, in 1986, enacted a statute to regulate CPA liability to third parties.

Liability may be imposed only if one of the following tests is satisfied: (1) privity of contract between CPA and plaintiff; (2) fraud or intentional misrepresentation; or (3) the CPA was aware that the primary intent of the client was to obtain the CPA's services to benefit or influence the particular person bringing action (Miller, GAAS: 112.10).

Accountants prefer this view to other more relaxed views because it severely limits third parties' ability to recover from negligent auditors.

Impact On The Accounting Profession

Accountants have watched, with growing fear, their liability risks increase over the past two decades. The number of lawsuits filed, the amount of jury awards, and settlements against accountants have increased. "According to available data (in 1987), the largest accounting firms collectively have paid more than \$250 million in settlements of mostly audit-related lawsuits since 1980" (Mednick: 119). Since then, large pay-outs from big cases have been highly publicized. For example, "Coopers agreed to pay \$95 million to settle claims related to the firm's

allegedly faulty audits for a former client, the now-defunct MiniScribe Corp" (C & L, Wall Street Journal). "In 1991, total (direct) expenditures for settling and defending lawsuits were \$477 million -- nine percent of auditing and accounting revenues in the United States" (Arthur Andersen: 2). Furthermore, in November of 1992 "Ernst & Young agreed to pay the government \$400 million to settle claims that its audits of hundreds of thrifts had been inadequate" (Holland: 76).

Because of the large liability risk, insurance rates have risen dramatically. "Insurance premiums for the largest CPA firms have multiplied by a factor of five since 1984; at the same time available commercial coverage has been cut in half. And deductibles have increased many times over" (Mednick: 119). The following quote demonstrates the impact of increasing liability on accountants' insurance rates.

The AICPA liability insurance plan's 1980 premium for firms with 25 professionals was about \$64 a person for \$1 million in coverage. By 1986 the premium had risen to about \$1,160 a person -- and the deductible had doubled (Mednick: 119).

Many small firms have been forced to drop their insurance coverage. In fact, "one out of five firms responding to a recent Wisconsin Institute of CPAs survey of its members indicated that it had been forced to drop its professional insurance coverage" (Mednick: 119). "Claims against firms other than the six largest rose by two-thirds between 1987 and 1991" (Arthur Andersen: 3). Consequently, many smaller firms no longer provide auditing

services because of high exposure risks and unaffordable insurance.

Larger public accounting firms have also suffered. Many have experienced a decrease in profit margin. Lower audit fees resulting from increased competition for clients, together with increasing insurance costs and legal fees, have diminished profits. "Mr Freedman, Chairman of Coopers & Lybrand, said that a reserve the firm set aside each year for liability insurance, legal fees and settlements of lawsuits was increased by about ten percent in fiscal 1992 because of litigation costs" (C & L, Wall Street Journal). Fear of bankruptcy from excessive damage awards, as happened with Laventhol and Horwath, is an increasing concern. Partners could be held personally liable to satisfy claims. Additionally, the threat of personal liability has had a negative effect on the recruitment of outstanding candidates into the profession and those in the profession seeking partnership positions.

Statement of Position

The aforementioned affects of litigation on the public accounting profession has prompted the six largest accounting firms to join together and draft a Statement of Position concerning the liability crisis. The "Big Six" state:

It (the tort liability system) is no longer a balanced system that provides reasonable compensation to victims by responsible parties. Instead, it functions primarily as a risk transfer scheme in which marginally culpable or even innocent defendants too often must agree to coerced

settlements in order to avoid the threat of even higher liability, pay judgments totally out of proportion to their degree of fault, and incur substantial legal expenses to defend against unwarranted lawsuits (Arthur Andersen: 1)

Often when a public company goes bankrupt the auditor is named in a suit filed by stockholder or creditors. Accountants believe "the motivation behind such suits seems to be the belief that no risk is to be born as simply bad luck or fate, but that all loss should be compensable by someone" (Minow: 72). Newton Minow continues by stating,

there is no justification for shifting the normal risks of investment from the investor to the accountant or, through accountants' liability insurance, to all investors or the public generally. The function of accounting is to provide information to those in the market who place capital at risk -- not to guarantee all such risks" (Minow: 79).

It appears as though accountants are being held responsible for business failures, not audit failures. Lawrence A. Weinbach, CEO of Arthur Andersen & Co. says "liability risk has gone so far, it's not worth the risk to audit some small companies, real estate ventures, financial services companies, initial public offerings, and small banks; the risk-reward tradeoff is out of whack" (Holland: 76).

High Risk Audits

Liability risk has made some audits impractical from a business standpoint. As a consequence, some companies might find it difficult to find a "Big Six" accounting firm willing to audit their books. Likewise, companies offering potential positive

contributions to society may never emerge, because they can not find an auditor for their initial public offering.

With growing regularity, major public accounting firms are turning their backs on many smaller banks, thrifts, and fledgling companies. Deloitte & Touche, for one, declined to audit about 60 companies trying to go public last year, more than half the 103 initial public offerings they actually evaluated (Holland: 76).

Since June of 1992, all audits of initial public offerings (IPOs) at Deloitte & Touche must be approved by the head office.

Audits of banks are also risky, due to of increasing regulatory requirements. Many banks in good financial condition are having trouble keeping their auditors or finding new ones. For example, Daniel Cargile, president and CEO of Tehama County Bank, in Red Bluff, CA stated "The bank was doing fine and had lots of excess capital....Ernst & Young didn't want to audit the bank anymore" (Holland: 76). When companies in good financial condition have trouble finding an auditor, society loses. Reform is needed.

Solutions

Many band-aid solutions to the liability crisis have been proposed over the years. Some proposed solutions favor accountants and others favor third-parties. Finding the fair solutions is difficult. Accountants want to eliminate joint and several liability, and would like a cap placed on punitive damages. Third-parties want to retain the joint and several liability concept so they can sue the accountant to recover

damages, when a co-defendant is bankrupt. The situation is fast reaching a crisis point. Accounting firms fearing bankruptcy, from possible liability claims, are beginning to turn away credible clients. Some compromise must be reached before the situation becomes intolerable.

It is clear that the audit function serves a purpose to society. Even dissenting Judge J. Kennard in *Bily v. Arthur Young & Co.* states,

Lenders and investors use the reports prepared by independent auditors so widely, and rely on them so heavily, that it is difficult to conceive how our complex modern capital markets would function if they were no longer available or no longer able to inspire confidence (*Bily v. Arthur*).

Some basic reforms are needed. To start, the legal system needs reform. Howard Stone believes defendants should "be able to point to falsities in complaints and thereby be allowed to have a complaint dismissed. At the present time the judicial system allows a complaint to be accepted as true...the defendant cannot argue against the truthfulness of the complaint."

A compromise in joint and several liability is needed. Currently, some states including Illinois have limited the accountants' liability to their degree of fault if the degree of fault is less than 20 percent.

The recovery of punitive damages also should be limited. However, Professor Harry Wright believes punitive damages should not have a cap. Rather, the plaintiffs should not receive the award. Any punitive damages awarded would instead be deposited

into a fund. The fund could be used to pay plaintiffs who can not recover because of bankrupt defendants, for SEC investigative costs, or to reduce the federal deficit. This proposed reform would resolve much of the debate surrounding punitive damages. The threat of large punitive damages remains to discourage unlawful acts, but the windfall for plaintiffs is no longer present.

Third-party liability needs to be defined in the form of legislation. Negligent auditors should be held liable to parties who relied on the audit reports. Legitimate plaintiffs should be able to bring a suit against an auditor even if the auditor was not "linked to the plaintiff." However, auditors should not be liable for an unlimited amount. Perhaps a per share limit or a per transaction limit could help auditors better assess the risk-reward trade-off of auditing a client and to help set fees.

Accountants' liability to third parties is clearly a complicated situation and any reform will be met with resistance from the group "giving up" something. Education for accountants, judges, lawyers, and the investing public is fundamental to the success of any reform.

APPENDIX A

Accountants' Legal Liability Questionnaire

Background Information

The accounting profession's view of the liability crisis in America is presented and discussed at great length in the classroom. My objective is to present a different perspective of this issue. The purpose of this interview is to gather your thoughts about accountants' legal liability.

Name of Interviewee: _____

Company: _____ Position: _____

Background: _____

1. Briefly describe your professional exposure to, or involvement with, accountants' legal liability?

Expectation Gap

Significant differences exist between the expectations of users of audited financial statements and the level of responsibility independent auditors are willing to assume. This situation is generally referred to as the "Expectation Gap."

2. In your opinion, what is the role of an independent financial statement auditor?

Bily v. Arthur Young & Co. Decision

A recently California Supreme Court decision (Bily v. Arthur Young & Co.) supported the opinion that an auditor owes no general duty of care regarding the conduct of an audit to persons other than the client. However, the auditor is liable for negligent misrepresentations in an audit report to those persons who rely upon those misrepresentations in a transaction which the auditor intended to influence. A dissenting judge believes the ruling gives negligent accountants broad immunity for their professional malpractice in rendering audit opinions.

12. What impact do you expect this court decision to have on future cases involving accountants' liability to third party users of audited financial statement?

Conclusion and Summary

The following questions will be used to summarize your thoughts and opinions about the liability crisis facing the public accounting profession.

13. Does the liability system in the United States require reform? If so, what do you propose?

14. What actions should public accounting firms take to protect themselves from the litigation onslaught?

15. How can third parties protect themselves from fraudulent financial statement audits?

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