

Bankruptcy of an Accounting Firm: Causes and Consequences of the Laventhal & Horwath Failure

Frederic M. Stiner, Jr.

Fairleigh Dickinson University

ABSTRACT

Laventhal and Horwath (L&H) was the seventh largest American public accounting firm when it failed in November 1990. Prior to its bankruptcy it had expanded rapidly, with a growth rate averaging 30% per year. During the 1980s, the firm=s aggressive leadership grew the firm largely through undertaking more than 65 mergers.

L&H became the largest and most expensive collapse of a partnership in U.S. history to that time. There were two causes of the failure: litigation and poor management policy choices concerning the danger of litigation. L&H was self-insured and had an aggressive policy of litigation, preferring court action to settlement. In its final year, 1990, one lawsuit was settled for \$10.5 million and litigation expenses were approximately \$1 million per month when a \$73 million judgment was entered in the *Westheimer* case. Another large, sensational lawsuit was pending: televangelist Jim Bakker and the PTL Ministry. At a partners= meeting in Dallas on Nov. 16, 1990, the partners were faced with two choices: either put in \$15 million from their own assets or file for bankruptcy. The firm filed for bankruptcy on Nov. 19, 1990.

There was enormous impact on employees, retirees, partners, clients, creditors, the profession and financial markets. For the 3,400 employees, there was no severance pay, and all insurance ceased immediately. L&H had no funded retirement plan, so for retirees, all monthly income payments and health insurance also ceased immediately. All partners from January 31, 1984 onward were brought into the bankruptcy, even if they had retired or resigned from the firm. Principals in the firm were also added to the lawsuit by the bankruptcy judge.

In the capital markets, hundreds of publicly-traded companies suddenly needed a new auditor for year-end. The SEC issued emergency instructions. Most of the public audit clients changed to one of the then Big Six firms. As a result of the L&H failure, there was a lobbying effort to limit partner liability by legislation; so eventually most states permitted the creation of a new business entity, Limited Liability Partnerships (LLPs). The second lobbying action was a lobbying effort to curtail class-action securities lawsuits. After contentious debate and an initial presidential veto, the U.S. Congress passed the Private Securities Litigation Reform Act of 1995. There are several lessons for firm management. First, growth through merger is extremely risky. Partners run the risk of merging into a lawsuit. Second, self-insurance does not work when there is a risk of ruin. Third, rapid growth through merger creates problems with quality control, resulting in an enormous cost in staff training. Another partnership failure such as L&H, with personal liability to all partners, cannot happen again, since all the major firms, including Arthur Andersen, converted to LLPs.

I. INTRODUCTION

Public accounting firms in the United States have operated in a litigious environment for decades. Failure of any publicly-traded company usually results in litigation where the auditors are joined as one of the defendants. For one such auditor, Laventhal and Horwath (L&H), this litigation caused the collapse of the firm. When it collapsed, it became the largest professional-services firm ever to fail (Cowan 1990b) until the failure of Arthur Andersen. Now that the litigation surrounding the bankruptcy is settled, it is possible to examine the causes of the collapse and the consequences to the employees, retirees, partners, clients, creditors, the accounting profession and the financial markets.

L&H was the seventh largest American public accounting firm when it failed in November 1990 (Table 1). There were 3,400 employees at the time of the failure, the largest office being the headquarters in Philadelphia, with 460 employees (Burke 1990).¹ Prior to its bankruptcy, L&H had expanded rapidly, growing from \$67 million in revenues in 1980, to \$345 million in its final year, 1990 (\$218 million in 1980 dollars). During the 1980s, the firm's aggressive leadership grew the firm largely through undertaking more than 65 mergers. At the time of the failure, there were 51 offices.

Laventhal and Horwath originated with two firms (Ferst and Lott 1983). Horwath & Horwath was one of the original firms, founded in Philadelphia in 1915 by two Hungarian immigrants. The other firm was Laventhal and Krekstein, founded in 1923. The two firms grew internally and through mergers, and in 1967 the two firms merged to create Laventhal, Krekstein, Horwath and Horwath, later shortened to Laventhal & Horwath. The firm was

¹ L&H had two offices in Philadelphia: one for the national headquarters at 1845 Walnut St., on Rittenhouse Square, and the other for the real estate practice at 11 Penn Center.

especially well-known for its hospitality industry clients ² and authoritative writing ³ in hotel and real estate operations.

In the U.S., securities defendants were subject to joint-and-several liability, so that even if only 1% of an economic loss is attributable to the negligence of one defendant, that defendant is liable for 100% of the awarded damages if other defendants are unable to pay. The independent accountant in the U.S. is seen by plaintiffs as the "deep pocket" whenever an audited company failed or even reported unexpected negative results (Lys and Watts 1994). L&H operated in this litigious economic environment without external insurance. The firm's philosophy had been that they did extremely high-quality work and they litigated any legal defense rather than settle. Since they had high-quality work and would not settle, the cost of litigation to a plaintiff would be very high with a low chance of success. Thus L&H reasoned that being self-insured was cost-effective.

TABLE 1
Largest Accounting Firms in the United States, 1989.
 Based on 1989 U.S. revenues; dollar amounts in millions:

<u>FIRM</u>	<u>U.S. PARTNERS</u>	<u>U.S. REVENUE</u>	<u>INTERNATIONAL REVENUE</u>
1. Ernst & Young *	2,131	\$2,259 **	\$4,460 **
2. Arthur Andersen	1,322	1,990	3,380
3. Deloitte & Touche *	1,652	1,847	Unavailable
4. KPMG Peat Marwick	1,881	1,770	4,300
5. Coopers & Lybrand	1,252	1,275 **	2,875 **
6. Price Waterhouse	845	1,100	2,460
7. Laventhal & Horwath	456	350	664
8. Grant Thornton	321	205	772
9. BDO Seidman	303	175	842
10. McGladrey & Pullen	377	157	468
11. Kenneth Leventhal	67	141	381
12. Pannell Kerr Forster	125	98	335
13. Spicer & Oppenheim	86	75	419

* Pro forma data, reflecting merger in 1990 of Ernst & Whinney and Arthur Young into Ernst & Young, and merger of Touche Ross and Deloitte Haskins & Sells into Deloitte & Touche.

** Estimated.

Source: *Bowman's Accounting Report, 1989*, cited in Burke (1990).

2 These included Rouse & Associates, Gerald Hines, Crown American, Trammel Crow, Marriott, Holiday Inn, and Hyatt (Covaleski 1990).

3 *Uniform System of Accounts for Restaurants* (National Restaurant Association, rev. ed., 1996) is still in print as of August, 2009.

II. CAUSES OF THE COLLAPSE

The Expectations Gap

There is a difference between what the auditors say that they do when they perform an audit, and what the public believes that the auditors do. This is known as “the expectations gap.” The collapse of companies after the 1960s’ bull market caused lawsuits and Congressional hearings.⁴ Those events induced the American Institute of Certified Public Accountants (“AICPA”) to form a Commission on Auditors’ Responsibilities in October 1974, the Cohen Commission. The Cohen Commission report (Commission on Auditors’ Responsibilities 1978) discussed this expectations gap and how it might be closed. The Public Oversight Board was formed by the AICPA in 1977 to oversee reporting for the SEC Practice Section.⁵ The goal was to create more confidence in audited financial statements.

Still the lawsuits kept coming, as one corporate-reporting scandal after another appeared. One important response of the profession was to issue nine new *Statements on Auditing Standards* in April, 1988: SASs 53-61. These were SASs 53 and 54 regarding fraud and illegal acts; SASs 55, 56, 57 on detecting material misstatements; SASs 58 and 59 on communicating the nature and results of the audit; and SASs 60 and 61: communicating with audit committees.

These SASs did not succeed in educating financial statement users nor reduce the number of lawsuits, because the auditing profession was ultimately overwhelmed by two crises: the liquidation of the savings and loan industry, and the collapse of L&H. L&H was the largest and most expensive collapse of a partnership in U.S. history to that time, with \$10.7 billion in bankruptcy claims eventually filed (*Laventhal and Horwath*). This paper traces the causes of the collapse to both the economic environment and specific decisions of the firm as it changed its strategy to grow. I argue that there were two causes of the failure: the ease with which plaintiffs can initiate litigation, and poor L&H management policy choices concerning the danger of litigation to a rapidly-growing firm. As stated before, L&H had an aggressive policy of litigation, preferring court action to settlement.

There were two architects of the growth of L&H, whose actions many blame for its collapse: Kenneth Solomon and George Bernstein. Solomon became chairman of the national council of L&H in 1976, and Bernstein was named the executive partner overseeing the entire firm’s operations in 1980. They undertook an aggressive campaign to grow through acquisition. Overall quality declined because many of the merged firms were not operating at L&H’s competence level. Lawsuits grew in numbers and expense, particularly in the Chicago office, which was headed by Solomon. L&H had the dubious distinction of being the first CPA firm to lose a racketeering lawsuit (Berton 1990c), which was a final sign that mergers without quality control had increased the practice management risk level.

In its final year of operation, litigation expenses were approximately \$1 million per

⁴ The Metcalf hearings (U.S. Senate 1976) on *The Accounting Establishment* and the Moss hearings (U.S. Senate 1977) on *Accounting and Auditing Practices and Procedures*.

⁵ This group voted to terminate itself as of March 31, 2002 when the Public Company Accounting Oversight Board was created. <http://www.publicoversightboard.org/about.htm>

month (Brown 1992b) when a \$73 million judgment was entered in the *Westheimer* case (Macey and Kennedy 1995).⁶ There were 30 defendants in the case; Laventhal was the only one who went to trial rather than settle. To appeal this judgment, the firm would have to post bond. In March, 1990, banks issued a \$5.5 million letter of credit towards payments in the lawsuit, in exchange for a security interest in L&H assets (Macey and Kennedy 1995). Another large lawsuit, with very negative, sensational publicity, began in October, 1990; this was televangelist Jim Bakker and the PTL Ministry (Cowan 1990b; *Teague v. Bakker*). Defending the Bakker-PTL lawsuit was expected to cause more cash outflow. The negative publicity had already caused some clients to change firms. The firm found it difficult to bring in new clients.

The cash problem became obvious to the business community in April, 1990, when profit pay-outs to partners were reduced, and layoffs were announced by the new executive partner-elect (Berton 1990a). The firm lost 30 partners and 200 professional staff when its Toronto unit joined Price Waterhouse (Berton 1990b). This damaged L&H's hopes to expand as an international firm and hurt its ability to service global clients. There were reports that Chase Manhattan, a major lender, was pressuring the firm to sell off its instruction and valuation divisions to raise needed cash (Berton 1990b). In the last year of L&H's existence, many of the consultants were reported to be leaving to form their own firms, join other firms, or take early retirement. Eventually, Solomon was passed over to be Bernstein's successor; Solomon quit.

On Oct. 26, 1990, the firm cut all salaries by 10% (Cowan 1990c). Negative publicity continued. L&H countered on Nov. 12 with a press release denouncing "embittered ex-partners" as the source of the stories and the problems (L&H 1990), clearly referring to Solomon. In the final three years of existence, L&H paid out \$50 million in lawsuit settlements (Anonymous 1990c). Heavy borrowing from banks was not able to provide cash for the litigation and other expenses, as nervous banks began to curtail credit. At a partners' meeting in Dallas on Nov. 16, 1990, the 320 partners in attendance were faced with two choices: either put in \$15 million from their own assets to go forward with the legal appeal of the *Westheimer* case, or file for bankruptcy (McGarth 1991).

The firm filed for bankruptcy on Nov. 19, 1990. They filed for bankruptcy in the southern district of the New York, not in Philadelphia. Clearly, they were "judge shopping" (Fix 1991). This was to be a wise choice, for the judge assigned to the case, U.S. Bankruptcy Court Judge Cornelius Blackshear, was to fashion a creative solution to the bankruptcy. The solution is one that has been copied in later bankruptcies of professional firms (Macey and Kennedy 1995). There was immediate alarm in the plaintiff bar that plaintiffs would not collect on all the damages they had planned for L&H, but they reassured themselves about insurance recoveries (Jensen 1990). Apparently they were unaware that the firm was self-insured.

⁶ *Westheimer v. Finesod*, U.S. District Ct. Southern District of Texas, no. H-86-3808. The original judgment was for \$36.5 million, but then was increased for pre-trial interest.

III. CONSEQUENCES

Impacts on Individuals

There were enormous impacts on employees, retirees, partners, clients, creditors, the profession and financial markets. For the more than 3,400 remaining employees, there was no severance pay, and all insurance ceased immediately. L&H had no funded retirement plan, so for retirees, all monthly income payments and health insurance ceased immediately. For the 629 partners and principals at the time of the failure, only 534 had positive net worth as a result of bankruptcy process. Principals in the firm were also added to the lawsuit by the court. All partners from January 31, 1984 onward were brought back into the bankruptcy, even if they had retired or resigned from the firm.

TABLE 2
Important dates for Laventhal & Horwath.

1907	Ernest B. Horwath and Edmund J. Horwath immigrate to the U.S., develop the first food cost accounting system.
1915	Horwath & Horwath founded in New York
1923	Lewis J. Laventhal and I. H. Krekstein form Laventhal and Krekstein in Philadelphia
August 20, 1967	Laventhal, Krekstein, Horwath and Horwath formed in Philadelphia
April 16, 1990	Pay-outs to partners reduced. Firm has 425 partners, 4,700 professional and administrative employees.
November 16, 1990	Final partners' meeting in Dallas. Bankruptcy decided. Firm has 350 partners, 3,273 professional and administrative employees.
August 24, 1992	Bankruptcy planned confirmed.

Sources: various, see text.

Within days of the bankruptcy filing, some partners formed their own firms.⁷ Others joined national firms.⁸ The choice seemed to be related to whether or not the local partners had merged into L&H or come up through the organization. If they had merged, they retained the same local client base, reassuring the press that the bankruptcy was caused by the national office and had nothing to do with the local office. On the other hand, if they came up through L&H and had contacts with national clients, then their incentive was to approach other national firms. For example, in the specialty area of hotel operations, Coopers & Lybrand was able to create the National Hospitality Industry Consulting Group by including five offices from Laventhal's leisure group (Covaleski 1990). Some non-accounting consultants formed their own firms.⁹

In the *Laventhal & Horwath* filing (1990), L&H listed \$146 million in assets, including \$81 million in net receivables. The largest creditors were Fidelity Bank of Philadelphia, owed \$59 million, and Chase Manhattan Bank, owed \$25 million. The other large payable was \$37 million in litigation settlements payable. The partner deficit was \$7 million. In the filing, L&H stated there were at least 100 lawsuits pending against the firm in both state and federal courts, for about \$2 billion (Pae 1990).¹⁰ The most notorious of these lawsuits was a \$184 million claim related to televangelist Jim Bakker and PTL.

Judge Blackshear took a novel course. He recognized that there were few tangible assets to liquidate, and the earnings potential of the partners and staff were the greatest asset. He promptly granted the partners an injunction prohibiting the attachment of their personal assets by creditors (Anonymous 1991). The injunction protected the partners from personal litigation by the partnership creditors, and being litigated against by other partners. This reduced the incentive for individual partners to file for personal bankruptcy. In exchange for this, the partners agreed to not transfer assets outside the reach of creditors; transfers for living expenses and to create new firms were excluded. The arrangement provided incentive for the former partners to work creating firms which would service the clients of L&H, including collecting the receivables. The partners who had been with small firms acquired by L&H suddenly found themselves liable for lawsuits arising from actions prior to their joining the partnership.¹¹

7 For example, the director of the Seattle office's hospitality division created his own firm taking the clients with him (Anonymous 1990a); the Kansas City office became several local firms (Butcher 1990); 79-year-old M.B. Haritan reformed his old accounting firm with several other partners and 70 staff in Washington DC (Aun 1991) while other partners created another local firm; the Baltimore office returned to being the firm it was before being acquired by L&H (Herschmeyer 1990); the Charlotte office created a local firm, and asked large public clients such as Family Dollar Stores to go elsewhere for their audit (Boudrow 1990).

8 For example, the six members consulting division of the Las Vegas office moved to Coopers & Lybrand (McKee 1990); two partners and 11 others moved from the St. Louis office to Cooper's and Lybrand (Goodman 1990); 27 members of the Costa Mesa office went to BDO Seidman (Anonymous 1990b); six partners and 60 staff of the San Francisco office went to BDO Seidman, making it one of BDO Seidman's largest offices (Watson 1990).

9 For example, the Miami office health care consultants created a firm (Bilodeau 1990).

10 Later claims expanded this to \$10.7 billion, but the court reduced as to about \$2 billion (Anonymous 1992).

11 For example, Allan Katz, who had been a partner for only a few months in 1984, when his firm merged with

The judge dragged back into the suit all who had been partners since January 31, 1984 even if they had resigned or retired, on the theory that much of the problems with the audit engagements giving rise to litigation began that far back. All retired partners also lost their retirement payments and health benefits, whether they had been included in the bankruptcy or not. There were 100 principals, and they were placed into the suit as defendants since they shared in the profits. They later were allowed to leave with a payment of \$5,000 each.

Judge Blackshear then created a plan where the amount of partner liability was based on the amount of profits which they had shared, rather than being jointly-and-severally liable for all the uncovered debts of the partnership. There were 20 partners considered to be key partners and their responsibility for contributions was increased because of their involvement in national management decisions. New local practices were encouraged. Having former L&H partners continue with clients in new firms gave the greatest possibility to collect receivables. Partners who took business with them, had those practices valued, and those values were considered as part of the amount each partner would pay. Partners were permitted ten years to pay the balance due after the calculations were complete. The court then provided that there would be a 20% discount for immediate payment (Finnigan 1992).

The plan of L&H, confirmed on Aug. 24, 1992, provided for contributions of \$47 million by the 629 current and former partners from their personal assets (Brown 1992b). The average partner payment was \$75,000, with the highest amount being \$391,400 paid by Bernstein and \$365,900 by Solomon. Fidelity Bank of Philadelphia and Chase Manhattan were repaid in full since they were secured by the receivables. On the other hand, the litigants in the securities cases which precipitated the collapse fared badly in recovery. Unsecured creditors received between 3.5 cents and 7.4 cents per dollar on what they were owed (Brown 1992b). The 160,000 PTL ministry creditors, who demanded \$129 million in damages in the bankruptcy, were treated as any other unsecured creditor (Anonymous 1992). Eventually, 7,000 creditors shared about \$48 million.

Impact on the Profession and the Markets

In the capital markets, hundreds of publicly-traded companies suddenly needed a new auditor for year-end. L&H had approximately 30,000 clients. Of these, there were 1,300 audit clients, of whom about 300 were publicly-traded. The Securities and Exchange Commission required that all former audit clients of L&H disclose the effect, if any, the bankruptcy would have on the audit (SEC 1991; Berton 1991). If the previous L&H auditor was unable or unwilling to sign the audit report, additional audit work was necessary. One estimate was that the additional audit work for clients changing auditors increased the audit costs 30%. The AICPA issued emergency instructions on retrieving work papers from a bankrupt CPA firm and signing reports when the previous year's statements had been audited by a bankrupt auditor. The SEC issued rulings on extension of time to file financial statements, disclosure of auditor change, substituted statements, and selection of a new auditor. Most of the public audit clients, such as Trans World Airlines, changed to Big Six firms.

L&H, was originally assessed \$90,000. He was able to get that reduced (Brown 1992a).

The failure of L&H provided an experiment to test “the insurance hypothesis.” There have been articles in the literature which argue that since damaged investors can sue auditors to recover losses, all audits are actually insurance (for example, Wallace 1987). Menon and Williams (1994) found that L&H’s bankruptcy had a negative market price effect on L&H clients, especially for IPOs. They attribute the declines to the loss of the insurance provided by the audit. Baber et al. (1995) found the same negative market decline, but suggest that the decline might also reflect investor doubt about the quality of the audit done by a failed firm.

Reed et al. (2000) present evidence that there is a demand for audit quality, evidenced by the choice of the then Big 6 or non-Big 6 firms when all the public clients had to make an involuntary change of auditors at the same time. These authors present evidence that when controlled for size, the clients preferred to associate with Big 6 firms. This was especially true for firms which were highly leveraged, with low management ownership in the firm, and which issued more securities in the year following the L&H bankruptcy.

Limited Liability Partnerships

The L&H failure indicates that the profession has been unable to overcome the expectations gap. Years of attempting to educate the financial public on what it is that auditors do, had clearly failed. Instead, the profession switched to politics. There was a massive lobbying effort by CPA firms in two areas. One was to limit auditor liability by legislation in most states, permitting the creation of a new business entity, Limited Liability Partnerships (LLPs). The second lobbying action was a massive lobbying effort to curtail class-action lawsuits.

At the time of the L&H failure, accounting was dominated by the Big Six accounting firms, who had the most to gain by limiting partner liability. Their first step was to have the AICPA approve accountants practicing in some other form of business organization than partnerships. The AICPA did that in Aug.1990 (Cowan 1990a), before L&H failed. They lobbied heavily for the passage of a law that would shield their personal assets from liability in the event that a firm failed (Rosen, 1994). One consequence was legislation enabling the creation of legislation permitting Limited Liability Partnerships (LLP) and Limited Liability Corporations (LLC). By December, 1995, 48 jurisdictions permitted LLCs (Cecil et al. 1995). Under most of these laws, partners or stockholders have unlimited liability only for their own acts and omissions. Acts and omissions of other partners can cause the loss of another partner's investment, but no longer will that other partner's personal assets be attached for a settlement. The new LLPs retain the tax advantage of being pass-through entities, so that earnings can pass to the partners untaxed at the partnership level.

The creation of the LLPs provide more opportunities to test the insurance hypothesis. O'Reilly et al. (2000) have found that financial analysts assign higher prices to companies where there is auditor liability than they do to companies where there is no auditor liability. The authors suggest that the presence of auditor liability might induce society to over-invest in risky companies. As further support for the insurance hypothesis, Chung et al. (1998) found that there was negative market reaction for a Big Six firm's clients at the time that firm converted to LLP status. The reaction was especially strong for riskier clients, in keeping with the notion that a larger insurance premium has been removed.

The second action proposed was to curtail class-action shareholder lawsuits. A Coalition to Eliminate Abusive Securities Suits (CEASS) was formed by corporations and firms who had been targets of the suits (Mantilla 1993). CEASS pointed out a number of behaviors which suggested that lawyers were motivated by their own greed rather than the best interest of their clients. For example, some law firms were paying finders' fees for promising lawsuits, and even in successful lawsuits, most of the proceeds went to the plaintiffs' lawyers, not to the shareholders who were allegedly injured. Corporations wasted valuable resources producing documents for frivolous claims. Investment bankers, accountants, and others were discouraged from working with high-risk and small companies because of the threat of litigation in abusive suits. L&H and other professional firms that failed were frequently cited.¹² Congressional hearings were held. The Chairman of the AICPA, Jake L. Netterville (1993), testified before the Senate Banking, Housing, and Urban Affairs Subcommittee. His testimony is summarized in Table 3. The lobbying effort pitted most professionals on one side and the trial lawyers associations on the other side.

TABLE 3
Arguments by AICPA for the Private Securities Litigation Reform Act

1. Meritorious and non-meritorious claims are treated the same.
2. Defrauded investors recover only a few cents on the dollar after attorney's fees are deducted.
3. Business managers are reluctant to provide unexpected information that is not mandated.
4. Unfair and excessive liability is impeding the profession to assume new responsibilities.

Source: Netterville (1993); Anonymous (1993).

Proposals for change went nowhere; it appears that large political campaign contributions from the plaintiffs' bar influenced Congress. This changed when the Republicans swept the November, 1994 elections, gaining control of both houses of Congress, including for the first control of the House of Representatives in 40 years. The Republicans ran on a platform called "Contract With America," one of the provisions of which was tort reform. There was a renewed heavy lobbying effort by the large accounting firms for tort reform.

12 The ones usually cited are four law firms and three accounting firms. The law firms are: Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey (failed 1988); Myerson & Kuhn (failed 1989); Heron, Burchette, Ruckert & Rothwell (failed 1991); and Gaston & Snow (failed 1991). The most frequently cited accounting firms, besides L&H, are Pannell Kerr Foster and Spicer & Oppenheim, both of which failed in 1991. See Macey and Kennedy (1995) for the description of how the bankruptcy courts learned from each failure.

In late 1995, after sharp debate, the Private Securities Litigation Reform Act ("PSLRA") was passed. President Clinton, whose party hoped to encourage political campaign contributions from Silicon Valley in the coming elections, shocked and embarrassed the Democrats by vetoing the bill (Frisby and Taylor 1995). President Clinton was the recipient of millions of dollars in trial lawyer campaign contributions, and a target of personal lobbying by prominent members of the plaintiffs' bar in the hours before his veto. Nevertheless, the bill was then passed into law over his veto.¹³ The major features of the law are: an end to fishing expeditions, sanctions for frivolous lawsuits, the lead plaintiff is selected by the court, proportionate liability, forward-looking information is permitted ("safe harbor"), and a codification of auditors' responsibilities for fraud detection (Andrews and Simonetti 1995).

Before the act, lawsuits could be filed with vague pleas, and then through the use of discovery, produce voluminous information which the plaintiffs could sift for specific claims. Now claims must be specific at the start. Under the new law, if a claim is found to be frivolous, attorneys' fees and other costs can be accessed. "Professional plaintiffs," who acted as lead plaintiff, would no longer receive a larger portion of the settlement than any other plaintiff. The first attorney to file a lawsuit does not automatically become lead counsel in a shareholder class-action lawsuit; the "race to the courthouse" ended. Joint-and-several liability encouraged inclusion of "deep pockets", such as auditors, who may be the only ones solvent at the end of a lawsuit. Under the new law, damages would be proportionate. To discourage lawsuits over missed forecasts, the "safe harbor" provision protected companies which provided more information about the future to shareholders. Auditors' responsibilities were codified (Andrews and Simonetti 1995).

The provisions of the act pleased management and auditors. CPAs benefit especially from the provision regarding joint-and-several liability, forward-looking statements, and fraud detection (Pincus 1995). Defendants who knowingly violate the securities laws still are subject to joint-and-several liability; however, unwary auditors are not. The court does not have to follow a strict proportionate liability, and has the latitude to increase the defendant's liability by as much as 50% of the original percentage liability, for especially negligent defendants. Small plaintiffs, defined as those with less than \$200,000 net worth and who lose 10% or more of that net worth due to the securities fraud, may still find all defendants jointly-and-severally liable.

With forward-looking statements, projections and predictions are exempt from liability if they are labeled with "meaningful cautionary statements." Further, in order to receive damages, the plaintiff must prove that a person making the forward-looking statement knew it to be false. CPAs' opinions about management projections are protected. This specifically removes the basis for many of the lawsuits which L&H lost.

The provisions of the law regarding fraud write into law the standards that the AICPA promulgated regarding audit scope and illegal acts. Once management has been informed of an illegal act, if the illegal act has the material effect on the financial statements and senior management has not taken action, with the result that the audit report will be changed from the standard report, the auditor must report of the Board of Directors. The board in turn must notify the SEC of the auditors' report within one day. If the board does not go to the SEC, the

13 Pub. L. No. 104-67, 109 Stat. 737 (1995).

auditor must notify the SEC within one day. These provisions, of course apply only to federal lawsuits. Auditors may still be vulnerable in state courts.

Researchers are still developing insight into the consequences of the PSLRA. For example, the quality of cases which come to court seems to have improved (Perino 2003) and frivolous lawsuits have been curtailed (Johnson et al. 2002).

There is another consequence to the bankruptcy which is emerging, possible revisions in the law for partnership bankruptcies (Macey and Kennedy 1995). Bankruptcy law in the past has been more oriented to the liquidation of firms with intangible assets. In the liquidation of a partnership which involves service activities, often more value is maintained by having those assets transfer to former partners, rather than to be sold to the highest bidder. This was true in the case of the L&H, where partners in local offices had a better chance of minimizing damage to creditors by using the assets, assuming the lease of the bankrupt firm, collecting receivables, generating new business, and otherwise keeping the entity intact.

IV. CONCLUSIONS

From the failure of L&H, there are several lessons for firm management. First, growth through merger is extremely risky. Partners, whether with the acquiring firm or with the smaller firm, run the risk of merging into a lawsuit for the other firm's prior work. Second, with the risk of acquiring other companies with unknown quality controls, and acquired staff of variable abilities and skills, the cost of insurance should rise with the risk. Self-insurance does not work when there is a risk of ruin.¹⁴ Third, rapid growth through merger gives problems with quality control, resulting in an enormous cost in staff training.

While firms can fail, as Arthur Andersen did 2002, partners no longer run the risk of losing their personal assets because of the actions of partners they never met. All the major firms converted to LLPs, and for the former Andersen partners not involved in lawsuits, it remains to be seen if they have any risk other their capital investment. Furthermore, the PSLRA increases the cost to a plaintiff of going forward with a lawsuit which has weak merits. The attest function is necessary for capital markets to function, but the personal cost to auditors is not as high as it was in the event of a failure.

As the markets have become global, there must be global harmonization of the attest function. The near-instantaneous transmission of financial information (through EDGAR and other sources) may mean that the audit in the future will be a continuous audit of the internal accounting control, rather than a year-and verification of balances and transactions.

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¹⁴ As one partner of a newly-formed partnership in Kansas City said, "We will have full insurance from day one." (Butcher 1990).

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Frederic M. Stiner, Jr. Ph.D., CPA
Department of Accounting, Taxation and Law
Fairleigh Dickinson University
H-DH-2-06
1000 River Road
Teaneck NJ 07666
Contact: stiner@verizon.net

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