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An Analysis of the Economic Consequences of the Proportionate Liability Rule*

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Abstract

Major accounting firms in the United States have singled out elimination of joint and several liability as one of the most needed legal reforms in the country. The recent legislation of the Private Securities Litigation Reform Act of 1995 replaced joint and several liability with proportionate liability. This paper develops a simple model to analyze the economic consequences of such a change in the legal environment facing public accountants. In particular, we examine the incentive effects induced by the proportionate liability rule on the auditor's effort and financial statement users' litigation decisions. Our analysis demonstrates that replacing joint and several liability with proportionate liability can decrease the equilibrium audit effort, lawsuit probability, market price of the firm, and audit fee. More important, even though the proportionate liability rule reduces the equilibrium audit effort, we show that it can actually increase social welfare.

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