

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

DEREK K. CHAN, SUIL PAE

First published: 20 April 2010

<https://doi.org/10.1111/j.1911-3846.1998.tb00567.x>

Accessibility issue? [Request accessibility update.](#)

* Accepted by Richard Young. This paper is a revised version of the manuscript entitled "The Economic Consequences of Alternative Auditor Liability and legal Cost Allocations Rules", which is available from the authors upon request. The authors would like to thank Willem Buijink, Sunil Dutta, Jerry Feltham, Ron King, Jevons Lee, Eric Noreen, Dan Simunic, Brett Truman, Kit Pong Wong, Andrew Yim, and the seminar participants at the University of British Columbia, Hong Kong University of Science and Technology, the 1998 International Symposium on Audit Research, and the 1998 International Conference on Contemporary Accounting Issues for helpful comments. This paper has also benefited from valuable comments and suggestions from Rick Young (associate editor) and two anonymous referees.



PDF

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.

This website utilizes technologies such as cookies to enable essential site functionality, as well as for analytics, personalization, and targeted advertising. You may change your settings at any time or accept the default settings. You may close this banner to continue with only essential cookies. [Privacy Policy](#)

Manage Preferences

Accept All

Reject Non-Essential

position). Reprinted by *Journal of Accountancy* 174 (5): 19–23.

[Google Scholar](#) 

Balachandran, B. V., and N. J. Nagarajan. 1987. Imperfect information, insurance, and auditors' legal liability. *Contemporary Accounting Research* 3 (2): 281–301.

[Google Scholar](#) 

Carcello, J., and Z-V. Palmrose. 1994. Auditor litigation and modified reporting on bankrupt clients. *Journal of Accounting Research* 32 (Supplement): 1–30.

[Web of Science®](#)  | [Google Scholar](#) 

Dye, R. A. 1993. Auditing standards, legal liability, and auditor wealth. *Journal of Political Economy* 101 (5): 887–914.

[Web of Science®](#)  | [Google Scholar](#) 

Dye, R. A. 1995. Incorporation and the audit market. *Journal of Accounting and Economics* 19 (1): 75–114.

[Web of Science®](#)  | [Google Scholar](#) 

King, R., and R. Schwartz. 1997. The private securities litigation reform act of 1995: A discussion of three provisions. *Accounting Horizons* 11 (1): 92–106.

[Google Scholar](#) 

Mednick, R. 1987. Accountants' liability: Coping with the stampede to the courtroom. *Journal of Accountancy* (September): 118–22.

[Web of Science®](#)  | [Google Scholar](#) 

Mednick, R., and J. Peck. 1994. Proportionality: A much-needed solution to the accountant's legal liability crisis. *Valparaiso University Law Review* 28 (2): 867–918.

This website utilizes technologies such as cookies to enable essential site functionality, as well as for analytics, personalization, and targeted advertising. You may change your settings at any time or accept the default settings. You may close this banner to continue with only essential cookies. [Privacy Policy](#)

Manage Preferences

Accept All

Reject Non-Essential

Narayanan, V. G. 1994. An analysis of auditor liability rules. *Journal of Accounting Research* 32 (Supplement): 39-59.

[Web of Science®](#) | [Google Scholar](#)

Nelson, J., J. Ronen, and L. White. 1988. Legal liabilities and the market for auditing services. *Journal of Accounting, Auditing and Finance* 3 (3): 255-95.

[Google Scholar](#)

Sarath, B., and M. A. Wolfson. 1993. *Auditing, litigation, and the volume of trade in a market framework*. Working paper, Stanford University.

[Google Scholar](#)

Schwartz, R. 1993. *The impact of liability rules and auditing standards on audit quality*. Working paper, Northwestern University.

[Google Scholar](#)

Shibano, T. 1996. *Overguarding the guardians: Increasing auditor liability decreases new investment*. Working paper. University of Chicago.

[Google Scholar](#)

Smith, R., and D. E. Tidrick. 1995. *The effect of alternative judicial systems and litigation costs on auditing*. Working paper, University of Texas at Austin.

[Google Scholar](#)

Citing Literature



This website utilizes technologies such as cookies to enable essential site functionality, as well as for analytics, personalization, and targeted advertising. You may change your settings at any time or accept the default settings. You may close this banner to continue with only essential cookies. [Privacy Policy](#)

Manage Preferences

Accept All

Reject Non-Essential



Manage Cookies

Accessibility

Wiley Research DE&I Statement and Publishing Policies

HELP & SUPPORT

Contact Us

Training and Support

DMCA & Reporting Piracy

Sitemap

OPPORTUNITIES

Subscription Agents

Advertisers & Corporate Partners

CONNECT WITH WILEY

The Wiley Network

Wiley Press Room

Copyright © 1999-2026 John Wiley & Sons, Inc or related companies. All rights reserved, including rights for text and data mining and training of artificial intelligence technologies or similar technologies.

WILEY

This website utilizes technologies such as cookies to enable essential site functionality, as well as for analytics, personalization, and targeted advertising. You may change your settings at any time or accept the default settings. You may close this banner to continue with only essential cookies. [Privacy Policy](#)



Manage Preferences

Accept All

Reject Non-Essential