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EMERGING ISSUES IN AUDITOR LIABILITY IN SECURITIES LITIGATION FROM A DEFENSE PERSPECTIVE

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I. INTRODUCTION

While securities fraud lawsuits involving auditors are said to be relatively few in number as a percentage of total new filings,[1] auditors often come to be added as defendants in high-profile cases. In the past few years, for example, auditors have been named as parties in the four proceedings with the largest total dollar value settlements to date -- *Enron*, *WorldCom*, *Cendant*, and *AOL Time Warner*[2] -- and in several other well-known actions including *Global Crossing*, *Tyco* and *Parmalat*. With the majority of all cases alleging accounting irregularities and over 90% of last year's filings reportedly containing alleged misrepresentations in financial documents, suits against auditors are never far off.[3]

This article reviews first the role of the auditor and reminds counsel of the benefits of weaving into each case the theme that the auditor does not prepare a company's financial statements; rather, the auditor opines on the fair presentation of management's financial representations based on the auditor's testing those representations. This article then surveys three areas of law germane in suits against auditors: (1) scienter requirements with respect to auditors; (2) the scope of primary liability and "scheme" liability with respect to auditors; and (3) "one firm" theories asserted against international audit firms.

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[1] According to Cornerstone Research's "Securities Class Action Case Filings, 2006: A Year in Review," at 20, auditors were reportedly named as defendants in only one new securities fraud class action filed in 2006 (or one percent of new filings) and in only 3% of new cases filed in 2005 (and 4% of new cases filed in 2004). One must add to these figures cases in which auditors are named as defendants in amended complaints after the initial filings. Cornerstone's recent study on class action settlements notes that accountants have been involved in just under 20% of all post-PSLRA settlements. Cornerstone Research's "Post-Reform Act Securities Settlements, 2006 Review and Analysis," at 8.

[2] Nera Economic Consulting, "Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar," January 2007, at 5 (listing top ten shareholder class action settlements, in dollar terms, as of December 2006).

[3] PricewaterhouseCoopers' "2005 Securities Litigation Study", at 5 and 9, reports that historically more than half of all new cases filed contained allegations of accounting irregularities. Cornerstone Research's "Post-Reform Act Securities Settlements, 2006 Review and Analysis," at 8, similarly recites that accounting allegations continue to be included in approximately 55% of all cases. Cornerstone Research's "Securities Class Action Case Filings 2005: A Year in Review," at 19, reports that 92% of filings in 2006 alleged misrepresentations in financial documents, up from 88% in 2005 and 78% in 2004. The report also states that the percentage of complaints alleging specific accounting irregularities increased to 68 percent in 2006 from 44 percent in 2005 and that "[t]his trend continues to suggest that the litigation market is now more focused on the validity of financial results and accounting treatment of a firm's activities." *Id.* at 19.

II. THE ROLE OF THE AUDITOR

Counsel litigating securities cases involving auditors would be wise to revert back to the basics of what the auditor does. The auditor's liability in securities actions generally stems from the auditor's dissemination of audit opinions, issued at the conclusion of its annual audits of a company's year-end financial statements. The allegation generally against the auditor, whether under Sections 10(b) or 18 of the Exchange Act of 1934 or Section 11 of the Securities Act of 1933, or otherwise is one of misrepresentation in the annual audit report. While plaintiffs often assert otherwise, and putting aside theories of secondary liability discussed below, the auditor is not liable for misstatements appearing in the company's unaudited interim (Form 10-Q) financial statements or in other company announcements for the simple reason that the auditor makes no public representation regarding those unaudited financial statements.[4]

While the auditor's role may seem basic to some, courts and counsel often articulate the auditor's role inartfully or get it just plain wrong. Plaintiffs sometimes go further and assert that it is the auditor itself that prepares or is responsible for the company's financial statements. *See, e.g., In re Raytheon Securities Litigation*, 218 F.R.D. 354, 356 (D. Mass. 2003) ("The Second Amended and Consolidated Class Action Complaint alleges that . . . PwC issued materially false and misleading financial statements in violation of the Generally Accepted Accounting Principles."). Oftentimes, courts pick up on and repeat without analysis these formulations. *See, e.g., In re Cendant Corp. Securities Litigation*, 343 F.3d 658, 660 (3rd Cir. 2003) (referencing Ernst & Young LLP as the "auditor who prepared the Cendant financial statements at issue in the underlying litigation"). As yet another variant, courts often refer to the auditor as having "certified" the financial statements, which may be less inaccurate depending on the circumstances, but nevertheless is still not quite right. *See, e.g., Overton v. Rodman & Co., CPAs, P.C.*, 478 F.3d 479 (2nd Cir. 2007) (reciting that "[t]he auditor had issued certified financial statements."); *Tricontinental Industries, Ltd. v. PricewaterhouseCoopers, LLP*, 475 F.3d 824, 828 (7th Cir. 2007) (PwC "certified that Anicom's financial statements were accurate").

The independent auditor does not, indeed cannot, prepare a company's financial statements and at the same time opine on those statements. Rather, financial statements are prepared by the company's management. Once management has prepared the company's financial statements, the auditor engaged by management conducts audit procedures in accordance with generally accepted auditing standards (GAAS) in order to assess on whether the company's financial statements fairly present for the relevant period the company's financial position and operations in all material respects in accordance with generally accepted accounting principles (GAAP). The Supreme Court has summarized part of the process as follows:

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[4] Unless the auditor undertakes to review and issue a published report on the interim financial statements, the auditor is only liable for its published audit reports on the company's annual financial statements, even though newly-adopted federal regulations (17 C.F.R. § 210.10-01(d)) may require the company's auditor to "review" quarterly financial statements. The Second Circuit recently reaffirmed this rule in a case against Deloitte & Touche LLP. *Lattanzio v. Deloitte & Touche LLP (Warnaco Sec. Litig.)*, 476 F.3d 147, 154-156 (2d Cir. 2007) (no auditor liability for alleged misstatements in unaudited quarterly financial statements) (*citing Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) and *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26 (D. Mass. 1994)).

> In an effort to control the accuracy of the financial data available to investors in the securities markets, various provisions of the federal securities laws require publicly held corporations to file their financial statements with the Securities and Exchange Commission. Commission regulations stipulate that these financial reports must be audited by an independent certified public accountant in accordance with generally accepted auditing standards. By examining the corporation's books and records, the independent auditor determines whether the financial reports of the corporation have been prepared in accordance with generally accepted accounting principles. The auditor then issues an opinion as to whether the financial statements, taken as a whole, fairly present the financial position and operations of the corporation for the relevant period.

U.S. v. Arthur Young & Co., 465 U.S. 805, 810-11 (1984).

The auditor's report is generally the best place to go to find a concise statement of the process followed by the auditor to reach his opinion. The auditor's report is carefully drafted and generally closely follows a prescribed form. The standard audit opinion provides:

> We have audited the accompanying balance sheets of X Company as of December 31, 20XX and 20XX, and the related statements of operations, stockholders' equity , and cash flows for each of the three years in the period ended December 31, 20XX. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.
>
> We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States).[5] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
>
> In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 20XX and 20XX, and the results of its operations and its cash flows for each of the three years in the period

[5] Prior to enactment and implementation of the Sarbanes-Oxley Act of 2002, audit opinions concerning the financial statements of public companies recited that the audit was conducted in accordance with generally accepted auditing standards (GAAS). However, Section 103 of the Sarbanes-Oxley Act mandated that the newly-formed Public Company Accounting Oversight Board (PCAOB) set auditing standards and also required that public company auditors adhere to all PCAOB standards. 15 U.S.C. § 7213. In 2003, the PCAOB adopted the then-existing auditing standards set by the American Institute of Certified Public Accountants (AICPA). Accordingly, audit opinions regarding the financial statements of SEC registrants now recite that audits are conducted in accordance with the standards of the PCAOB.

> ended December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.
>
> We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 20XX, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and in our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 20XX, is fairly stated, in all material respects.[6]

It is worthwhile educating the court from the outset as to what the auditor actually undertakes to do. It is useful to teach and then remind the court at each juncture that the company, under the direction of its chief executive officer and chief financial officer, prepares and takes responsibility for company financial statements. The auditor tests those statements to determine whether they are free of material misstatement and thereafter to express an opinion on them. The differentiation between the company and the auditor is crucial to the successful defense of auditor suits. For example, at the motion to dismiss stage, an educated court that understands the limits of the role played by the auditor is more likely clearly and independently to examine issues such as whether the complaint adequately alleges that the auditor made a material misstatement of its undertaking -- an audit in accordance with GAAS -- or did so with the requisite scienter (separate and apart from whether the company issued a misstatement or did so with scienter). Similarly, towards the end of a case, an educated court will more likely allow detailed jury instructions on proportionate fault as to the auditor if it understands that, in the first instance, the company's management prepared the allegedly misleading financials. Below are two recent examples of where a focus on the limited role of the auditor has potentially impacted litigation favorably.

[6] Section 404 of the Sarbanes-Oxley Act of 2002 now requires public companies to include in their financial reports a separate assessment of the company's internal control structure and procedures for financial reporting and requires the company's auditor "to attest to and report on" management's internal control assessment. 15 U.S.C. § 7262. Neither the SEC nor the PCAOB has issued definitive guidance on the standards by which the internal control assessments are to be conducted. The auditing profession and the SEC seem to agree for now that a set of standards issued in 1992 by an offshoot of the accounting profession provide an appropriate standard. The standards are set forth in a report entitled "Internal Control - Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), a private-sector initiative supported by the largest professional accounting associations and institutes, including the AICPA. The COSO report examines factors that cause fraudulent financial reporting and makes recommendations to reduce their incidence and it provides a framework against which organizations can review and enhance their internal control systems.

A. Example 1, ***Deephaven v. Grant Thornton*** (10th Cir. 2006)

In *Deephaven Private Placement Trading, Ltd. v. Grant Thornton*, 454 F.3d 1168 (10 Cir. 2006), plaintiffs brought suit against Grant Thornton under Section 18(a) of the Securities Exchange Act of 1934 on account of their audit opinions on the financial statements of Daw Technologies, Inc. Section 18, infrequently used perhaps because reliance must be proven on an individualized basis, allows suits for misstatements made in certain SEC filings.[7]

In *Deephaven*, three institutional investors in Daw alleged that they invested in reliance on Grant Thornton's unqualified audit opinions on Daw's financial statements. Daw thereafter announced that its financial statements were inaccurate and would be restated, and the stock price fell. Plaintiffs sued Grant Thornton alleging that the 1999 financial statements did not present Daw's financial position fairly in conformity with GAAP and that Grant Thornton made a materially false and misleading statement when it opined that they did. The district court dismissed the complaint after reading into Section 18 a scienter requirement and finding that plaintiffs' complaint failed to allege scienter. The Tenth Circuit affirmed, but on different grounds. The Tenth Circuit found that Section 18 contains no scienter requirement but nevertheless held that alleging that a company's financial statements are in error or not prepared in accordance with GAAP does not adequately allege a misstatement by the company's auditors who may have opined on those financial statements. The Tenth Circuit clearly understood what an auditor, as opposed to company management, undertakes to do and accept responsibility for with respect to a company's financial statements.

The Tenth Circuit first outlined plaintiffs' allegations:

> Investors start with the supposition that when an auditor "certifies" a company's financial statements, which subsequently prove to contain a materially false or misleading statement, the auditor's certification is itself a false and misleading statement within the meaning of Section 18(a). Following that line of reasoning, they contend they fulfilled the [pleading requirement of alleging a misstatement] when they set forth in the [complaint] Grant Thornton's opinion that the 1999 financial statements present Daw's financial position fairly in conformity with GAAP. They maintain that they satisfied the [pleading] requirement when they specified how the 1999 financial statements were not so presented.

Deephaven, 454 F.3d at 1173.

The court explained: "But auditors do not 'certify' a company's financial statements in the sense that they 'guarantee' or 'insure' them. Nor do they, by virtue of auditing a company's financial statements, somehow make, own or adopt the assertions contained therein. Rather, the end product of an audit is the audit report, which usually contains three concomitant paragraphs:

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[7] Section 18 requires plaintiff to allege and prove that (1) the defendant made or caused to be made a statement of material fact that was false or misleading at the time and in light of the circumstances under which it was made, (2) the statement was contained in a document filed pursuant to the Exchange Act or any rule or regulation thereunder, (3) reliance on the false statement, and (4) resulting loss to the plaintiff. *Deephaven*, 454 F.3d at 1171 (citing Section 18, 15 U.S.C. § 78r(a)). Section 18 has no express scienter requirement.

the introduction, the scope and the opinion." *Id.* at 1174. The court examined in detail the three paragraphs of Grant Thornton's audit opinion, which closely tracked the standard form issued by the AICPA. The court noted that "[t]he opinion paragraph, as the term suggests, is stated as an opinion of Grant Thornton rather than a statement of absolute fact or a guarantee." Id. at 1175.[8]

The court then concluded "[s]imply alleging, as Investors do, that GAAP violations in 1999 financial statements rendered Grant Thornton's opinion materially false or misleading is inadequate." Id. at 1176. Rather, to allege adequately a misstatement by the auditor, plaintiffs would have had to specify how "(1) Grant Thornton did not actually form its opinion regarding the 1999 financial statements based on its audits; or (2) it did not have a reasonable basis for its opinion because it did not plan and perform its audits of the 1999 financial statements in accordance with GAAS." Id. The court also answered plaintiffs argument that the court's holding would in effect interject a scienter requirement into Section 18. The court responded: "To be sure, Section 18(a) has no scienter requirement. But it is no answer to argue that the lack of a scienter requirement in Section 18(a) excuses Investors' failure to sufficiently specify the reasons why Grant Thornton's opinion was false or misleading in the context of its stated basis." *Id.*, at 1177.

Overall, the *Deephaven* case provides an excellent example of the positive results that may flow when the court understands the auditor's role and understands that liability of a company and its auditor are not coextensive.

B. Example 2: Loss Causation

A second example of how litigation may get interesting when parties focus the court on the circumscribed role the auditor plays arises in the context of loss causation. Following the Supreme Court's decision in *Dura Pharma., Inc. v. Broudo,* 544 U.S. 336 (2005), loss causation has been the subject of much litigation. To the extent one understands that the auditor issues a professional opinion on financial statements for which company management alone assumes responsibility, the following question arises under *Dura*: what constitutes a sufficient "corrective disclosure" to trigger damages attributable to the audit opinion? Is disclosure of a material misstatement of the financials sufficient, or must the disclosure also speak to the audit opinion, both to its objective and subjective falsity.

While no reported decision directly answers this question, the building blocks are in place for a legal explication. First, pursuant to the Supreme Court precedent of *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991), to establish the falsity of an opinion in the fraud context, a plaintiff must establish its subjective and objective falsity. Second, *Virginia Bankshares* applies with equal force to audit opinions, that is, to show the falsity of an audit opinion, a plaintiff must establish not just its objective falsity but also the subjective falsity of the opinion. *See, e.g., Ezra Charitable Trust v. Tyco Int'l Ltd.*, 466 F.3d 1, 13 (1st Cir. 2006) (referencing subjective falsity standard in context of assessing auditor scienter for allegedly misleading audit

[8] While the *Deephaven* court did not reference the Supreme Court decision in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991), that decision buttresses the *Deephaven* holding. In *Virginia Bankshares* the Supreme Court held that for an opinion, albeit one issued by a banker, to be found false under Section 14(a) of the 1934 Exchange Act, the plaintiff must prove both objective and subjective falsity thereof. 501 U.S. at 1092-94.

opinion). Third, *Dura* limits recovery to stock price drops caused by market awareness of the original misstatement. Fourth, and ergo, to satisfy *Dura's* requirement of market awareness of the auditor's alleged misstatement (his opinion), the market should become aware of the subjective falsity of the audit opinion.

Again, while no reported decision has directly reached this holding, a parallel strain of case law suggests the ruling may not be far off. In the context of analyst opinion cases, courts have held that under *Dura* a market disclosure constitutes a cognizable corrective disclosure only if the disclosure indicates the analyst's opinion at issue was subjectively false. *Swack v. Lehman Brothers, Inc.*, No. 03-10907-NMG, 2005 U.S. Dist. LEXIS 42588, *10-11 (D. Mass. Aug. 17, 2005) (dismissing Section 10(b) claims against analyst for having issued an allegedly false stock rating because, while the market had learned objective facts inconsistent with that rating, it did not learn that the analyst's opinions were not honestly held); *In re Initial Public Offering Sec. Litig.*, 399 F. Supp. 2d 298, 308 (S.D.N.Y. 2005) (dismissing case as to analysts because "plaintiffs' failure to allege a corrective disclosure of the falsity of defendants' opinions precludes any claim that the opinions caused their loss."); *Joffee v. Lehman Bros. Inc.*, 2006 WL 3780547 (2nd Cir. Dec 19, 2006) (unpublished) (affirming dismissal on loss causation grounds in analyst opinion case because "plaintiffs here never allege that the falsity of the defendants' opinions was ever revealed to the public."); *see also Glover v. DeLuca*, 2006 WL 2850448 (W.D. Pa. Sep 29, 2006) ("There are two methods of establishing loss causation, which have been distinguished as follows: Where the alleged misstatement conceals a condition or event which then occurs and causes the plaintiff's loss, it is the materialization of the undisclosed condition or event that causes the loss. By contrast, where the alleged misstatement is an intentionally false opinion, the market will not respond to the truth until the falsity is revealed, i.e., a corrective disclosure.").

In summary, counsel litigating securities cases involving auditors should strive to consider how the limited nature of an auditor's opinion affects each aspect of the case and to educate the court at all junctures of the limited role the auditor plays with respect to a company's financial statements.

III. SCIENTER AS TO AUDITORS

It is elementary that plaintiffs bringing securities fraud claims under Section 10(b) of the Exchange Act of 1934 must establish intentional wrongdoing, or scienter, as to each defendant and that scienter refers to "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976). Moreover, it is established, at least with respect to pleadings, and presumably with respect to summary judgment and trial,[9] that plaintiffs must establish not just a reasonable inference of scienter, but a strong inference and must do that with particularity. Interestingly, as of the date of this manuscript, the Supreme Court has a case pending before it addressing the "strong inference of scienter" requirement. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484 (U.S.). *Tellabs* concerns the issue of how the district court should credit competing inferences in determining whether a complaint adequately pleads a strong inference of scienter and provides perhaps the first occasion for the Supreme Court to address directly the "strong inference" standard.[10] Regardless of how the

[9] *See* 15 U.S.C. § 78u-4(b)(2) (plaintiffs must plead "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."); *Geffon v. Micrion Corp.*, 249 F.3d 29, 36 (1st Cir. 2001) (PSLRA's heightened pleading standards apply at summary judgment stage); *Tse v. Ventana Med. Sys., Inc.*, 123 F. Supp. 2d 213, 225-26 (D. Del. 2000) (same). *But see Howard v. Everex Systems*, 228 F.3d 1057, 1064 (9th Cir. 2000) (while strong inference of scienter applies at pleading stage, for summary judgment and trial purposes, plaintiffs need prove no more than a rational inference of scienter); *In re Bristol-Myers Squibb Securities Litigation*, 2005 WL 2007004, *16 (D.N.J. Aug 17, 2005) (similar).

This issue may well be resolved by the Supreme Court in the pending case *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484 (U.S.). While the difference between pleading and proof standards was not the issue before the court, at the March 28, 2007 oral argument, certain of the justices focused on whether the PSLRA's heightened pleading standard carries over to plaintiff's burden of proof at trial (thereby altering the traditional preponderance of evidence standard affirmed in *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390-91 (1983), to something higher), and if not, whether the Seventh Amendment's right to a jury trial is offended by allowing judges to dismiss cases at the pleading stage that otherwise might be adequate enough to be submitted to a jury.

[10] The issue presented in *Tellabs* is:

> Whether, and to what extent, a court must consider or weigh competing inferences in determining whether a complaint asserting a claim of securities fraud has alleged facts sufficient to establish a "strong inference" that the defendant acted with scienter, as required under the Private Securities Litigation Reform Act of 1995.

Defendants/Petitioners urge the Supreme Court to reverse the Seventh Circuit and rule that the district court must weigh all competing inferences, including facts that tend to support an inference of innocence, and decide which are most plausible and that when plaintiffs allege facts that are, at most, equally consistent on their face with either innocence or culpability, despite the benefit of having all well-pleaded facts treated as true, a strong inference of scienter should not be found and the complaint should be dismissed. Plaintiffs/Respondents ask the Supreme Court to affirm the Seventh Circuit's ruling rejecting defendants' proffered rule of weighing dueling inferences and allowing a complaint to survive if it alleges facts from which, if true, "a reasonable person could infer that the defendant acted with the required intent."

Supreme Court decides *Tellabs*, conclusory allegations will not suffice for pleadings and the authority set forth below should remain valid authority.

While the general scienter standard applies equally to issuer defendants, auditor defendants and other secondary actors, the courts have developed specific tests for scienter with respect to auditors.

A. Scienter Standards as to Auditor Defendants Are Especially Stringent

Recalling that plaintiffs can establish scienter by showing either actual, knowing conduct or recklessness so extreme that it approaches intentional conduct, most if not all plaintiffs seek to establish auditor scienter in Section 10(b) cases using the extreme recklessness standard. Because auditors are independent of the clients they serve and opine only with respect to the fair presentation of financial statements prepared by the client company itself, recklessness for purposes of alleged auditor scienter carries a heightened standard. *See Fidel v. Farley*, 392 F.3d 220, 226 (6th Cir. 2004) ("'[W]hen the claim is brought against an outside auditor, we have concluded that 'the meaning of recklessness in securities fraud cases is especially stringent.'") (*quoting PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 693 (6th Cir. 2004)). The courts hold that "[r]ecklessness on the part of an independent auditor entails a mental state so culpable that it approximate[s] an actual intent to aid in the fraud being perpetrated by the audited company." *Fidel*, 392 F.3d at 226 (citations and internal quotations omitted); *Rothman v. Gregor*, 220 F.3d 81, 98 (2nd Cir. 2000) (same).

To establish this approximation of actual intent to aid in the fraud, plaintiffs must show that the audit "amount[ed] at best to a 'pretended audit.'" *Rothman*, 220 F.3d at 98 (citation omitted). In other words:

> [S]cienter requires more than a misapplication of accounting principles. The plaintiff must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.

DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385, 390 (9th Cir. 2002) (citations omitted); *In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256 (3d Cir. 2006) (similar; alleged GAAS violations causing auditor to overlook thirty "red flags"); *In re Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 154 (D. Mass. 2001) (similar). That is, "even if [the auditor] should have done more to attempt to uncover and disclose the alleged fraud, without factual allegations tending to establish knowledge of those practices on [the auditor's] part, an auditor's failure to do more is legally insufficient." *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334, 390 (D. Md. 2004) (internal quotation marks and citation omitted). In contrast, "allegations of a seriously botched audit," while perhaps suggesting negligence or gross negligence, "do not give rise to a strong inference that the auditor acted with an intent to defraud, conscious misconduct, or deliberate recklessness, as is required in a securities fraud case." *DSAM Global Value Fund*, 288 F.3d at 387; *see also Ezra Charitable Trust v. Tyco International, Ltd.*, 466 F.3d 1, 12 n.10 (1st Cir. 2006) ("Alleging a poor audit is not equivalent to alleging an intent to deceive").

B. <u>"Red Flags" and Auditor Scienter</u>

Plaintiffs not infrequently attempt to show auditor scienter by alleging that the auditor-defendant knew of, but ignored, various "red flags" that should have alerted the auditor that financial figures were incorrect and fraudulently compiled. *See In re Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 154 (D. Mass. 2001) ("A plaintiff may satisfy this high burden by pleading with specificity that the auditor was aware of, but failed to investigate, certain 'red flags' that plainly indicated misconduct was afoot."); *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 694 (6th Cir. 2004) ("[T]o allege that an independent accountant or auditor acted with scienter, the complaint must identify specific, highly suspicious facts and circumstances available to the auditor at the time of the audit and allege that these facts were ignored, either deliberately or recklessly."); *In re IKON Office Solutions, Inc. Sec. Litig.*, 277 F.3d 658, 677 n. 26 (3d Cir. 2002) ("[I]n many cases the most plausible means to prevail on a section 10(b) claim against an auditor without that ever-elusive 'smoking gun' document or admission will be to show how specific and not insignificant accounting violations collectively raise an inference of scienter."). Courts have cautioned, however, that red flags must be truly red and obvious to the auditor. *Nappier v. PricewaterhouseCoopers LLP*, 227 F. Supp. 2d 263, 278 (D.N.J. 2002) (red flags "must be closer to smoking guns than mere warning signs.") (citation and internal quotation marks omitted).

Additionally, conclusory allegations that a circumstance amounted to a "red flag" or that the auditor must have known of the red flag establish nothing under the particularity pleading requirements. *Fidel v. Farley*, 392 F.3d 220, 230 (6th Cir. 2004) ("Because the class members' red flags rest on 'conclusory allegations' of what Ernst & Young must have known or should have known while preparing the audit report, we find that they do not create an inference that Ernst & Young acted with scienter."); *Ezra Charitable Trust*, 466 F.3d at 12 ("The presence of 'red flags' not acted upon by an auditor is not sufficient to raise a strong inference of scienter if there are no facts showing that the auditor knew (or willfully blinded itself to the knowledge) that the underlying facts, if properly accounted for, would result in significant changes to audited financial statements."); *Schiller v. Physicians Resource Group, Inc.*, 2002 WL 318441 (N.D. Tex. Feb 26, 2002) (similar).

C. <u>Existence of GAAP or GAAS Violations as Bearing on Scienter</u>

A perennial question in auditor cases regards the impact of allegations of violations of generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) on determinations of auditor scienter. While some might seek to portray GAAP as black and white rules that are only violated when one is acting to defraud, the courts acknowledge that application of GAAP involves significant judgment. The Supreme Court has recognized that GAAP "are far from . . . a canonical set of rules that will ensure identical accounting treatment of identical transactions. [GAAP], rather, tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management." *Thor Power Tool Co. v. C.I.R.*, 439 U.S. 522, 544 (1979); *see also Ezra Charitable Trust*, 466 F.3d at 12 ("GAAP can tolerate a range of reasonable approaches"). Thus, while a plaintiff may need to show that the auditor's work amounted to "no audit at all" or "a pretend audit" and that no reasonable auditor would have made the same judgment calls absent an intent to defraud, mere misapplication of

GAAP does not give rise to the requisite strong inference of scienter. It may evidence negligence, but that does not equate to an intent to defraud.[11]

As a matter of pleading, a plaintiff adds nothing by conclusorily alleging that a circumstance constituted a GAAP or GAAS violation or that the violation was an obvious one. *See Greebel v. FTP Software, Inc.*, 194 F.3d 185, 203-04 (1st Cir. 1999) (for an allegation of GAAP violation to be meaningful, "the complaint must describe the violations with sufficient particularity; 'a general allegation that the practices at issue resulted in a false report of company earnings is not a sufficiently particular claim of misrepresentation.' . . . the complaint clearly falls short [as it] does not include such basic details as the approximate amount by which revenues and earnings were overstated . . . the products involved in the contingent transactions . . . the dates of any of the transactions . . . or the identities of any of the customers or FTP employees involved in the transactions.) (*citing Gross v. Summa Four, Inc.*, 93 F.3d 987, 996 (1st Cir. 1996)); *In re Hypercom Corp. Sec. Litig.*, 2006 WL 726791, at *4-5 (D. Ariz. Jan. 25, 2006) ("Plaintiffs also contend that the obvious nature of Hypercom's GAAP violation creates a strong inference that Defendants acted with scienter. . . . [E]ven assuming that establishing the obviousness of a GAAP error could in fact establish a strong inference of scienter, Plaintiffs have not alleged sufficient facts to make such a showing. . . . [Plaintiffs'] conclusory claim alone does not establish the obviousness of the GAAP violation . . . they do not allege facts establishing the obviousness of the [GAAP error]."); *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390-91 (9th Cir. 2002) (similar); *SBC Computer Tech., Inc. Sec. Litig.*, 149 F. Supp. 2d 334, 357 (W.D. Tenn. 2001) (similar); *In re Faro Technologies Securities Litigation*, Slip Copy, 2007 WL 430731, *15-20 (M.D. Fla. Feb 03, 2007) (similar).

Similarly, a plaintiff who alleges the auditor violated GAAS in the conduct of its audit without specifying with particularity what the particular GAAS violation was and why it mattered adds nothing to its pleading burden. *In re Stone & Webster Sec. Litig.*, 414 F.3d 187, 214 (1st Cir. 2005) (plaintiff's "litany of conclusory allegations of failure to conform to GAAS standards" adds nothing); *Ezra Charitable Trust*, 466 F.3d at 13 ("the conclusorily presented 'laundry list' of alleged GAAS violations, which lack any specific ties to the alleged fraud at issue, do not get plaintiffs far in creating a strong inference of scienter."); *In re Cardinal Health Inc. Sec. Litig.*, 426 F. Supp. 2d 688, 778 (S.D. Ohio 2006) ("Plaintiffs have done no more than list these GAAS standards, failing to specify, who, where, when, or how E & Y actually violated them . . [and] these elements are crucial to a plaintiff's pleading. To that end, Plaintiffs' allegations are no more than a feeble attempt to convert vaguely pled GAAS violations into evidence of E & Y's scienter.").

However, while it is insufficient for a plaintiff to cite GAAS standards without an explanation of how the defendant knowingly or recklessly violated those standards, the complaint may withstand dismissal where, when coupled with significant "red flags," plaintiff articulates with particularity the GAAS violated and alleges how they were violated. *Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 279-80 (3d Cir. 2006) (reversing dismissal of complaint as to BDO Seidman finding scienter adequately alleged).

[11] *See, e.g., In re Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 154 (D. Mass. 2001) ("In the wake of the PSRLA, however, 'red flags' generally constitute something more than the accounting violation itself.").

Courts have held with near unanimity that GAAP violations alone do not give rise to a finding of scienter: "The mere misapplication of accounting principles by an independent auditor does not establish scienter." *Zucker v. Sasaki*, 963 F. Supp. 301, 307 (S.D.N.Y. 1997) (*citing SEC v. Pricewaterhouse*, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992)); *In re Sportsline.com Sec. Litig.*, 366 F. Supp. 2d 1159 (S.D. Fla. 2004) ("Violations of GAAP, without more, may establish negligence, but can never establish scienter."); *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000) ("Allegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim."); *Fidel v. Farley*, 392 F.3d 220, 230 (6th Cir. 2004) ("The failure to follow generally accepted accounting procedures does not in and of itself lead to an inference of scienter."); *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 627-28 (9th Cir. 1994) ("a failure to follow GAAP, without more, does not establish scienter."). The same rule applies with respect to the existence of accounting restatements. *Reisman v. KPMG Peat Marwick LLP*, 965 F. Supp. 165, 173 n.11 (D. Mass. 1997) (the fact of a restatement does not mean an auditor knew the original statements were false at the time they were issued or that the auditor can be held liable for fraud); *Ezra Charitable Trust*, 466 F.3d at 12 (same).

Indeed, if allegations of GAAP violations alone were sufficient, scienter would almost automatically become a non-issue in nearly half of all securities cases because allegations of GAAP violations are that prevalent.[12] When GAAP violations combine with other circumstances to suggest a fraudulent intent, however, then those violations may begin to be relevant to the scienter analysis. *See Reiger v. PricewaterhouseCoopers LLP*, 117 F. Supp. 2d 1003, 1009 (S.D. Cal. 2000) ("violations of GAAP . . . provide evidence of scienter only when accompanied by additional facts and circumstances that raise an inference of fraudulent intent."); *Ferris, Baker Watts, Inc. v. Ernst & Young, LLP*, 395 F.3d 851, 855 (8th Cir. 2005) (only where allegations of GAAP violations "are coupled with evidence of corresponding fraudulent intent might they be sufficient" to establish scienter); *In re Adaptive Broadband Sec. Litig.*, 2002 WL 989478, 2002 U.S. Dist. LEXIS 5887 (N.D. Cal. 2002) (supplementing allegations of GAAP violations with detailed evidence of the contemporaneous decision making behind the accounting errors, thereby showing that financial statements were known to be false at the time they were filed with the SEC and made available to the investing public, set forth sufficient evidence of scienter).

D. Size of GAAP Violations as Evidence of Scienter

Another related issue is whether a particularly large GAAP violation, in dollar terms, may on its own give rise to a finding of scienter. Logically, the size of a GAAP error alone should not lead to a finding of scienter. Some courts, nevertheless, have ruled that a relatively large financial misstatement, particularly when combined with other factors, may give rise to a strong inference of scienter. *See In re MicroStrategy, Inc. Securities Litigation*, 115 F. Supp. 2d 620, 637 (E.D. Va. 2000) ("the alleged GAAP violations and the subsequent restatements are of such a great magnitude--amounting to a night-and-day difference with regard to MicroStrategy's representations of profitability--as to compel an inference that fraud or recklessness was afoot."); *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324, 1339 (N.D. Ga. 1998)

[12] 68% of new securities case filings in 2006 reportedly contained allegations of GAAP violations (up from 44% of new filings in 2005). Cornerstone Research, "Securities Class Action Case Filings 2006: A Year in Review," at 20. Allegations of improper revenue recognition are the most prevalent of these, historically appearing in approximately half of all cases alleging GAAP. *Id.*

(misapplication of GAAP "when combined with a drastic overstatement of financial results can give rise to a strong inference of scienter"); *In re Baan Co. Sec. Litig.*, 103 F. Supp. 2d 1, 21 (D.D.C. 2000) ("the magnitude of the error can play a role" in inferring scienter); *In re Lernout & Hauspie Sec. Litig.*, 208 F. Supp. 2d 74, 88 (D. Mass. 2002) (GAAP violations combined with the magnitude of the overstatement of revenue provided strong indications of scienter); *In re WorldCom, Inc. Sec. Litig.*, 2003 U.S. Dist. LEXIS 10863, 22-23 (S.D.N.Y. June 25, 2003) ("Although the size of the fraud alone does not create an inference of scienter, the enormous amount at stake coupled with the detailed allegations regarding the nature and extent of WorldCom's fraudulent accounting and Andersen's failure to conduct a thorough and objective audit create a strong inference [of scienter.]"); *In re Enron Corp. Sec. Litig.,* 258 F. Supp. 2d 576, 625 n.55 (S.D. Tex. 2003) (similar).

One is left to wonder why the sheer magnitude of a financial misstatement alone should establish a strong inference of scienter when the courts acknowledge that application of accounting rules is inherently judgmental and that negligence and even gross negligence is not enough to show scienter. Certainly, if something in particular about the situation and the financial misstatement actually suggests an intent to defraud, then some inference may be logical. However, allowing large GAAP violations, without more, to point towards scienter seems unfounded. Courts that so acknowledge may have the more reasoned approach. *See, e.g., Fidel v. Farley,* 392 F.3d 220, 231-32 (6th Cir. 2004) ("We decline to follow the cases that hold that the magnitude of financial fraud contributes to an inference of scienter on the part of the defendant. Allowing an inference of scienter based on the magnitude of fraud 'would eviscerate the principle that accounting errors alone cannot justify a finding of scienter.'"); *In re Med/Waste. Inc. Sec. Litig.*, 2000 WL 34241099, at *8 (S.D. Fla. Aug. 30, 2000) ("to allow the magnitude of a misstatement or its falsity to satisfy the scienter requirement would ignore the reality that scienter and falsity are distinct elements of a Section 10(b) claim."); *In re MCI Worldcom, Inc. Sec. Litig.,* 191 F. Supp. 2d 778, 791 (S.D. Miss. 2002) (no scienter despite allegation that "sheer size of the write-off by WorldCom evidences fraudulent intent"); *Reiger v. PricewaterhouseCoopers LLP*, 117 F. Supp. 2d 1003, 1013 (S.D. Cal. 2000) ("Inferring scienter from the magnitude of fraud invites a court to speculate as to the existence of specific (but unpled and unidentified) warning signs that show the accountant acted with scienter. To travel from magnitude of fraud to evidence of scienter, the court must blend hindsight, speculation and conjecture to forge a tenuous chain of inferences . . . ."); *In re Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 155 (D. Mass. 2001) ("The magnitude of the misstatement . . . at most supports a garden-variety inference of recklessness or a strong inference of negligence -- but that is not enough.").

E. Relevance of Professional Fees

Because all auditors receive fees for their services, and because many auditors, particularly prior to enactment of Sarbanes-Oxley, provided non-auditing services to clients such as tax guidance and business consulting, plaintiffs frequently assert that the auditor's desire to receive ongoing audit and non-audit fees provided the motive for the auditor's fraud. Courts will only find fees relevant to supply a motive to explain auditor fraud, however, once sufficient "red flags" or other factors suggesting fraud already exist; standing alone, fee allegations do not themselves give rise to a strong inference of scienter. *See In re Philip Services Corp. Sec. Litig.*, 383 F. Supp. 2d 463, 470 (S.D.N.Y. 2004) ("a generalized economic interest in professional fees is insufficient to establish an accounting firm's motive to commit fraud."); *In re Stone & Webster Sec. Litig.,* 414 F.3d 187, 215 (1st Cir. 2005) (plaintiffs alleged the auditor-defendant was motivated by lucrative accounting and consulting fees; "[s]uch allegations can thus strengthen an inference of scienter predicated on other facts, possibly adding sufficient strength to satisfy the strong-inference requirement of PSLRA. On the other hand, absent truly extraordinary circumstances, an auditor's motivation to continue a profitable business relationship is not sufficient by itself to support a strong inference of scienter."); *Ezra Charitable Trust*, 466 F.3d at 13 (same); *Fidel*, 392 F.3d at 232 (allegations that the auditor earned and wished to continue earning fees from a client do not raise an inference that the auditor acted with the requisite scienter); *In re Enron Corp. Sec. Litig.*, 235 F. Supp. 2d 549, 679 (S.D. Tex. 2002) (large fees provided motive to ignore numerous red flags).

IV. PRIMARY LIABILITY FOR AUDITORS (AS SECONDARY ACTORS)

An ongoing issue in securities litigation involving auditors and other so-called secondary actors, and one that has been the subject of particular focus in recent cases, involves the extent to which auditors as secondary actors may be held primarily liable for a company's fraud. Certainly, the most common and least controversial method is when the auditor issues a clean audit opinion on financial statements later alleged to be materially misstated. In this instance, the auditor itself is alleged to have engaged in its own fraudulent behavior upon which the investing public relied. Moving beyond this scenario, the courts have long been faced with allegations that auditors should be liable not just for issuing allegedly misleading audit opinions, but also for assisting clients in their fraud. While *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994), put an end to "aiding and abetting" liability for auditors and other secondary actors, rulings in several of the recent, high-profile securities fraud cases have wrestled with the question of whether auditors, or other secondary actors, may be held liable in securities fraud cases where they themselves did not issue an allegedly false and misleading statement. Currently, the issue, in the context of outside vendors, is on review before the Supreme Court.[13]

A. <u>Auditor Liability for Providing Substantial Participation in the Making of Misleading Statement v. Aiding and Abetting Liability</u>

After the Supreme Court's landmark decision in *Central Bank*, securities fraud claims against auditors were generally limited to instances in which an auditor's report on a company's financial statements is alleged to be misleading. In *Central Bank*, the Supreme Court held that secondary actors, including banks, lawyers and auditors, cannot be held liable for aiding and abetting a company in its fraudulent misstatements under Section 10(b); instead, secondary actors can only be held liable under Section 10(b) for their own material misstatements or employment of manipulative devices. *Central Bank*, 511 U.S. at 177. The Supreme Court explained that allowing aiding and abetting liability inappropriately permits a claim to proceed without the critical element of reliance:

> Our reasoning is confirmed by the fact that respondents' argument would impose 10b-5 aiding and abetting liability when at least one element critical for recovery under 10b-5 is absent: reliance. A plaintiff must show reliance on the defendant's

[13] The Supreme Court granted certiorari in the Eighth Circuit *Charter Communications* case on March 26, 2007 to address the viability of scheme liability in light of *Central Bank*. *See Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.* 06-43 (U.S).

> misstatement or omission to recover under 10b-5. *Basic v. Levinson*, 485 U.S. at 243. Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions.

Central Bank, 511 U.S. at 180.

Subsequent to the *Central Bank* decision, most federal courts addressing the issue applied a "bright line" test pursuant to which a secondary actor like an auditor "must actually make a false or misleading statement in order to be held liable under Section 10(b)", as "[a]nything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be." *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998).[14] In *Wright*, plaintiff had alleged that the auditor had signed off on its client's financial figures, which it knew would be released to the public, and that the market allegedly knew and relied on the fact that the client's financial statements had been approved by the auditor. *Id.* at 171. Because the statements were neither made by the auditor nor attributed to it, however, there could be no liability under *Central Bank*. *Id.* at 175. *Wright* and other courts have required that "the misrepresentation must be attributed to [the defendant] at the time of the public dissemination, that is, in advance of the investment decision." *Id.*; s*ee also Ziemba v. Cascade Intel, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) ("we conclude that, in light of *Central Bank*, in order for the [secondary] defendant to be primarily liable under 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant."); *In re Ikon Office Solutions, Inc. Sec. Litig.*, 131 F. Supp. 2d 680, 685 n. 5 (E.D.Pa. 2001) (although accounting firm approved press release, press release failed to refer to accounting firm, and thus *Central Bank* compelled dismissal); *Great Neck Capital Appreciation Inv. P'ship, L.P. v. PricewaterhouseCoopers, L.L.P.*, 137 F. Supp. 2d 1114, 1121 (E.D.Wis. 2001) (auditor's assistance with press release by reviewing it and advising that it conformed with GAAP insufficient for primary liability; auditor did not draft, publicly adopt, or allow its name to be associated with release and therefore auditor's actions more closely conformed to "aiding and abetting," making imposition of liability inconsistent with *Central Bank*).[15]

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[14] *See also Ziemba v. Cascade Intel, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (following *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998)); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) (rejecting "a rule allowing liability to attach to an accountant or other outside professional who provided 'significant' or 'substantial assistance' to the representations of others" and holding that, to be liable, secondary actors "must themselves make a false or misleading statement (or omission)"); *Fidel v. Farley*, 392 F.3d 220, 235 (6th Cir. 2004) ("holding Ernst & Young liable for either its alleged implicit endorsement of the unaudited financial figures or for its failure to insist on a correction to these figures would effectively revive aider and abettor liability in contravention of the Supreme Court's holding in *Central Bank*."); *In re DVI, Inc. Sec. Litig.*, 2005 WL 1307959, *8 (E.D. Pa. May 31, 2005) (similar); *Sec. Exch. Comm'n v. Lucent Tech., Inc.*, 363 F. Supp. 2d 708 (D.N.J. 2005) (similar); *In re Kendall Square Research Corporation Securities Litigation*, 868 F. Supp. 26, 28 (D. Mass. 1994) (accountant's "review and approval" of financial statements and prospectuses insufficient basis to impose Section 10(b) liability).

[15] In *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996), rather than requiring that the auditor's statement be publicly attributed to the auditor when disclosed to the public, the Tenth Circuit held that "for an accountant's misrepresentation to be actionable as a primary violation, there must be a

In contrast, the Ninth Circuit and a handful of district courts have allowed liability to attach to auditors for statements actually made by the company where the auditor or other secondary actor "had significant participation" in the formulation of the misstatement. *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628 n. 3 (9th Cir. 1994) (holding that an accountant may be primarily liable based on its "significant role in drafting and editing" a letter sent by the issuer to the SEC); *In re ZZZZ Best Securities Litigation*, 864 F. Supp. 960, 970 (C.D.Cal. 1994) (accounting firm primarily liable for company misstatements where accountants were "intricately involved" in the creation of false and misleading company documents.[16] Under the Ninth Circuit test, the degree to which the allegedly misleading misstatement must be attributable to the secondary actor, if at all, for primary liability to attach is unclear. *In re Software Toolworks* did not address attribution while in *ZZZZ Best*, in seeming contravention of *Central Bank*, the court held:

> While the investing public may not be able to reasonably attribute the additional misstatements and omissions to E&Y, the securities market still relied on those public statements and anyone intricately involved in their creation and the resulting deception should be liable under Section 10(b)/Rule 10b-5.

ZZZZ Best, 864 F. Supp. at 970. The Ninth Circuit's "substantial participation" test has been criticized for resurrecting aiding and abetting liability. *See Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 n. 10 (10th Cir. 1996) ("substantial participation" test does not comport with *Central Bank*).

In several recent cases, the traditional application of *Central Bank* has been stretched significantly to impose liability on auditors even though they did not make the allegedly misleading statements and the statements were not directly attributed to them. For example, in *Lernout & Hauspie Securities Litigation*, 230 F. Supp. 2d 152 (D. Mass. 2002), plaintiffs alleged that Lernout & Hauspie's ("L&H") auditor, KPMG Belgium, had signed and issued materially misleading audit opinions. Further, plaintiffs alleged that the US firm, KPMG US, which did not sign or consent to the issuance of the KPMG Belgium audit opinions, nevertheless "played a significant role in drafting the financial statements and in conducting the audit." *Id.*, 230 F. Supp. 2d at 166-67. KPMG US was allegedly listed in L&H's annual report as one of L&H's principal auditors. The court allowed these allegations to satisfy the reliance requirement that the statements be attributed to the secondary actor: because "KPMG US's role as an auditor was publicly disseminated in the annual reports to shareholders," "[i]t is also appropriate to infer that in 1998 and 1999, investors reasonably attributed the statements contained in the quarterly and annual reports to KPMG US." *Id.* This test waters down, if not eliminates, the requirement

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showing that he knew or should have known that his representation would be communicated to investors."

[16] *See also Cashman v. Coopers & Lybrand*, 877 F. Supp. 425 (N.D. Ill. 1995) (primary liability established against accountants who were "centrally involved" in preparation of alleged false or misstated information for prospectuses or promotional material issued to investors). In *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998), the court adopted a similar test urged by the SEC acting as amicus curiae whereby the auditor "can be primarily liable when it, acting alone or with others, creates a misrepresentation even if the misrepresentation is not publicly attributed to it" and even if the auditor does not sign the alleged misstatement.

affirmed in *Central Bank* that a secondary actor can be liable only if the plaintiff relies on the secondary actor's own misstatement; and it does so be creating a fiction that the market will assume that statements not attributed to an auditor are nevertheless made by that auditor simply by virtue of the public's alleged awareness that the auditor has served the company in an audit capacity.

Going further, the Lernout & Hauspie court ruled that the separate firm, KPMG UK, might be liable for statements made by others which it allegedly helped prepare even though there was no attribution of those statements to KPMG UK. The plaintiffs had alleged that KPMG UK had actually prepared aspects of, and provided disclosures for, L&H's 1998 financial statements, but, unlike KPMG US, the UK firm was not even mentioned as one of L&H's auditors in its public statements. *Id.* at 168-69. The court nevertheless ruled that liability could attach:

> Absolving an auditor who prepares, edits, and drafts a fraudulent financial statement knowing it will be publicly disseminated simply because an affiliated auditor with which it is working under a common trademark is the one to actually sign it, would stretch *Central Bank*'s holding too far.

Id. at 168-69. In contrast, the court held that KPMG Singapore, which audited L&H's operations in Singapore and reported to KPMG Belgium that the financial statements with respect to those operations were presented in all material respects in conformity with GAAP, could not be liable as a primary violator even though KPMG Belgium incorporated those conclusions into its global audit report. *Id.* at 171. The court reasoned:

> Even if KPMG Belgium partially relied on KPMG Singapore's conclusion that L & H's Singapore operations and revenues were fairly presented in issuing its 'clean" audit report, there is no caselaw to support plaintiff's theory that KPMG Singapore made a material misstatement or omission upon which investors relied. Second, KPMG Singapore did not prepare, draft, edit or provide numbers for the audit. Its role was more akin to the "review and approval" allegations which no court has found sufficient to trigger liability after *Central Bank*.

Id. at 171. While the court in this instance correctly recognized *Central Bank* and its progeny, the *Lernout* court seems to ignore it elsewhere in its decisions. Additionally, the court's reasoning here is unsatisfactory as auditors do not "prepare, draft, edit or provide numbers for the audit" nor, except in the most extraordinary of circumstances, be credibly alleged to have done anything more than opine regarding whether a company's financial statements are fairly presented, as KPMG Singapore apparently did here.

In *Global Crossing, Ltd. Securities Litigation*, 322 F. Supp. 2d 319 (S.D.N.Y. 2004), the court followed the lead of *Lernout & Hauspie* and found primary liability as to Global Crossing's auditor, Arthur Andersen, on account of statements of a financial nature made by the company in press releases and unaudited financial statements not directly attributed to the auditor. While Andersen had audited the company's financial statements in 1998-2000, the bulk of the allegedly misleading statements were made by the company in press releases, unaudited quarterly financial statements and pro forma financials in 2001, a year in which Andersen did not audit Global Crossing's financial statements. *Id.* at 331. Plaintiffs alleged generally that Andersen reviewed and materially assisted in the preparation of the company's financial disclosures and press releases relating to financial issues. *Id.* at 334. Plaintiffs also alleged that Andersen had issued an aggressive "white paper" on accounting in the telecommunications industry which was well-known to industry insiders. *Id.* The court held that "[t]hese allegations are sufficient to raise a reasonable inference not only that Andersen was one of the 'makers' of the statements, but also that investors viewed it as such." *Id.* One is left to wonder exactly how to square *Global Crossing* with *Central Bank*, or how to reconcile it and *Wright* in which the Second Circuit held the alleged misstatement must be publicly attributed to the secondary actor before liability may attach. In *Global Crossing*, the unaudited quarterly financial statements were not only not attributed to Andersen, but for the year in question, Andersen did not opine on the company's financial statements.[17]

Commentators have noted that some of these recent cases imposing primary liability on secondary actors seemingly have "outflanked the Supreme Court's decision in *Central Bank of Denver* and largely restored private 'aiding and abetting' liability under a different name." John C. Coffee, "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms," 84 B. U. L. Rev. 301, 337 (2004). Whether appellate courts will have an opportunity and act to reign in the recent trend in expanding liability for auditors and secondary actors, particularly in high profile cases, remains to be seen.

[17] In two other cases from the Southern District of New York plaintiffs attempted to define, or redefine, auditor liability where the alleged misstatements were not directly attributed to them. In *In re Elan Corp.*, 2004 WL 1305845, *26 (S.D.N.Y. May 18, 2004) (report and recommendation by magistrate judge; never adopted by district court because of intervening settlement), the magistrate judge recommended dismissal of Section 10(b) claims against KPMG-US where the company's audit opinion was issued by KPMG-Ireland based on KPMG-US's audit work on the U.S. operations. Plaintiff argued that KPMG-Ireland's opinion that Elan's financial statements conformed to U.S. GAAP constituted an "implicit" representation that KPMG-US agreed. The magistrate judge rejected this argument, explaining "even if this Court were to conclude that *Lernout & Hauspie* correctly states the applicable law, the Section 10(b) and Rule 10b-5 claim against KPMG-US would have to be dismissed because there is no suggestion in the Complaint that KPMG-US's role in the audit process, rather than being surmised by investors, was in fact disclosed to them in some fashion by Elan." In *Teachers' Retirement System of Louisiana v. ACLN Ltd.*, 2004 WL 2997957, *5 (S.D.N.Y. Dec 27, 2004), however, plaintiffs were successful. The court explained, with respect to BDO Seidman, that "[a] plaintiff may state a claim for primary liability under Section 10(b) for a false statement (or omission), even where the statement is not directly attributed to the defendant, where the defendant's participation is substantial enough that it may be deemed to have made the statement and where investors are sufficiently aware of the defendant's participation that they can be found to have relied on it as if the statement had been directly attributed to the defendant.").

B. Scheme Liability Under Rule 10b-5 subsections (a) and (c)

Another developing theory of liability as to secondary actors, and one as to which the Supreme Court is set to speak, is the so-called "scheme liability" under subsections (a) and (c) of Rule 10b-5.

1. Contours of Scheme Liability

While Section 10(b) itself prohibits actors from engaging in "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of any registered security, Rule 10b-5 promulgated thereunder has been interpreted by some courts as providing a basis for further liability even though the court in *Central Bank* clearly explained that the scope of Rule 10b-5 may not exceed that of Section 10(b). *Central Bank,* 511 U.S. at 173.

Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) to employ any device, scheme or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit on any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

In certain recent, well-publicized cases, plaintiffs have attempted with varying degrees of success to exploit Rule 10b-5(a) and (c) and apply scheme liability theory to include as defendants third party vendors, banks and even auditors who had some relationship with the company that allegedly engaged in fraud but who themselves did not make any fraudulent misrepresentation. To date, three Circuit Courts have directly addressed the viability of "scheme liability" with one court accepting it (*Simpson v. AOL Time Warner,* 452 F.3d 1040, 1048 (9th Cir. 2006)) and two rejecting it (*In re Charter Communications*, *Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006) and *Regents of the University of California et al. v. Credit Suisse First Boston (USA), Inc. et al (Enron Sec. Litig.)*, --F.3d --, 2007 WL 816518 (5th Cir. March 19, 2007)). Additionally, the United States Supreme Court granted certiorari in *Charter Communications* on March 26, 2007 to address the viability and contours of scheme liability. *See Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.* 06-43 (U.S).[18]

[18] The question presented in the *Charter Communications* case now before the Supreme Court is "[w]hether th[e] Court's decision in *Central Bank* [], forecloses claims for deceptive conduct under § 10(b) [] and Rule 10b-5(a) and (c) [] where Respondents engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where Respondents themselves made no public statements concerning those transactions."

In *Central Bank*, the Supreme Court ruled that private rights of action under Section 10(b) and Rule 10b-5 are limited to (1) those involving misstatements (or omissions) and (2) those employing a manipulative device or scheme. *Central Bank*, 511 U.S. at 191 ("As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.").[19] The Circuit Courts which reject scheme liability as to secondary actors engage in a straight forward analysis whereby they affirm that: (1) as per *Central Bank*, Rule 10b-5 cannot be broader than Section 10(b); (2) pursuant to *Central Bank*, Section 10(b) only prohibits misstatements (or actionable omissions) and market manipulative devices or schemes; and (3) as ruled in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476-77 (1977), a manipulative device or scheme is a limited term of art encompassing only manipulative securities trading practices such as "wash sales, matched orders, or rigged prices." Because the activity at issue in cases involving alleged financial statement fraud generally does not fall into these categories of manipulation, secondary activity amounts to nothing more than non-actionable aiding and abetting liability. *In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006) (no liability for vendors of set-top cable boxes who sold their boxes to Charter Communications at inflated prices subject to a kickback agreement pursuant to which they would direct the value of overpayment back to Charter in the form of advertising purchases and where alleged scheme was knowingly carried out by vendors to allow Charter to misrepresent its revenue); *Regents of the University of California et al. v. Credit Suisse First Boston (USA), Inc. et al (Enron Sec. Litig.)*, --F.3d --, 2007 WL 816518 (5th Cir. March 19, 2007) (no liability for banks that entered into deals with Enron to purchase Enron assets temporarily with Enron's promise to re-purchase them shortly at higher prices even though banks allegedly knew scheme was designed to allow Enron to record revenue from transactions when it was in fact incurring debt).

In contrast, in *Simpson v. AOL Time Warner*, 452 F.3d 1040, 1048 (9th Cir. 2006), the Ninth Circuit upheld scheme liability and adopted the "principal purpose and effect" test. In that case, third-party vendors had allegedly been involved in Homestore.com's scheme to defraud whereby Homestore.com would purchase goods or services from vendors that it did not need on the agreement that the third parties would purchase advertising from AOL and AOL would then share the advertising revenue with Homestore.com, which Homestore would book as revenue. The Ninth Circuit announced: "We hold that to be liable as a primary violator of § 10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme. It is not enough that a *transaction* in which a defendant was involved had a deceptive purpose and effect; the defendant's *own conduct* contributing to the transaction or overall scheme must have had a deceptive purpose and effect." *Id.*

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[19] *Central Bank* cited *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977) ("language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception") and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) ("When a statute speaks so specifically in terms of manipulation and deception . . . , we are quite unwilling to extend the scope of the statute").

2. Application of Scheme Liability as to Auditors

While scheme liability has been addressed and applied in recent cases against various secondary actors including banks, venture capital funds, etc., it is rarely upheld against auditors.[20] One of the few (if not only) cases upholding scheme liability as to auditors is *Global Crossing*, 322 F. Supp. 2d 319, 335-36 (S.D.N.Y. 2004). In that case, while the court upheld primary liability against the auditing firm Arthur Andersen for its role in materially assisting in the preparation of the company's financial disclosures under a Rule 10b-5 subsection (b) misstatement theory, the court also upheld liability against Andersen for its alleged participation in a scheme to defraud under Rule 10b-5 subsections (a) and (c). The court explained "[i]t is apparent from Rule 10b-5's language and the caselaw interpreting it that a cause of action exists under subsections (a) and (c) for behavior that constitutes participation in a fraudulent scheme, even absent a fraudulent statement by the defendant." Thus, the court ruled Andersen could be held liable not only for its allegedly misleading audit opinions but also for its separate conduct "springing from practices that are not reflected in the audited financial reports", namely for Andersen's alleged central role in creating the accounting schemes allegedly used to inflate Global Crossing's revenue. *Id.* at 337. The court either undermined *Central Bank* by simply applying a scheme liability label to aiding and abetting conduct or it actually divined some line between merely aiding and abetting another's fraud and actively participating therein.[21] The court explained

> plaintiffs' allegations against Andersen go far beyond mere aiding and abetting. All that is required in order to state a claim for a primary violation under Rule 10b-5(a) or (c) is an allegation that the defendant (1) committed a manipulative or deceptive act (2) in furtherance of the alleged scheme to defraud, (3) scienter, and (4) reliance.

Global Crossing, 322 F. Supp. 2d at 336. The court continued and recited plaintiffs' allegations:

> Andersen masterminded the misleading accounting for IRUs [indefeasible rights of use] and the subsequent sham swap transactions used to circumvent GAAP and inflate the Companies' revenues, that it actively participated in structuring each swap, that it was intimately involved in all of [the Companies'] accounting functions, and that it directly participated in the creation of the misleading 'pro forma' numbers that concealed these practices from investors. Andersen's

[20] For example, in *In re WorldCom, Inc. Sec. Litig.*, 203 U.S. Dist LEXIS 10863, at 33-34 (S.D.N.Y. June 25, 2003), where plaintiffs tried to ensnare Andersen's UK firm and its international umbrella organization under a scheme liability theory, the court disallowed it noting that the complaint did not allege the existence of any scheme to defraud, nor did the complaint identify any false information that the related entities contributed to any arguable scheme or actions they took to facilitate a scheme.

[21] In addressing plaintiffs' claims for Andersen's fraud based on the company's unaudited financial statements, the court noted that of course scheme liability cannot be used as a "short cut" to circumvent *Central Bank's* prohibition on aiding and abetting liability and thus Andersen "may not be held liable for any of the individual unaudited *statements* made by AGC under Rule 10b-5(b), although it may be held liable for the fraudulent *scheme* behind them [under Rule 10b-5(a) and (c)]." *Global Crossing,* 322 F. Supp. 2d at 337 n.17.

> allegedly central role in these schemes, as their chief architect and executor, leaves no doubt as to its potential liability as a primary violator under section 10(b).

Id.

3. Specific Issues with Scheme Liability

Several problems have arisen with respect to the application of scheme liability that may limit its application, at least with respect to auditors. Certainly, the issues are being resolved already by the circuit courts with conflicting results and the Supreme Court will presumably provide guidance in *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc. (Charter Communications)*, 06-43 (U.S)), which may be argued in late 2007.

a. Definition of "Manipulative or Deceptive Device or Contrivance"

One issue that courts wrestle with is whether the text of Section 10(b), as interpreted by the Supreme Court, allows for scheme liability in ordinary fraud on the market cases. Again, Section 10(b) prohibits "any manipulative or deceptive device or contrivance."[22] While Rule 10b-5(a) and (c) bar "any device, scheme or artifice to defraud" and "any act, practice, or course of business which operates or would operate as a fraud or deceit on any person," the *Central Bank* court ruled that Rule 10b-5 can be no broader in scope than Section 10(b). Thus, the question courts face is whether Section 10(b) even allows for "scheme liability."

Courts finding no room for scheme liability revert to *Central Bank's* summary that Section 10(b) liability is limited to those who either "employ[] a manipulative device" or make a material misrepresentation. 511 U.S. at 177 ("As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.").[23] Thus, the only hook available under the statute for scheme liability lies in the text's prohibition of manipulative devices. Next, the Supreme Court has repeatedly held that the definition of "manipulative device" is sufficiently limited so as to render scheme liability of little utility in most securities cases. In *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), which *Central Bank* cited in its discussion of the meaning of "manipulative" devices, the Supreme Court commented that

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[22] Section 10(b), codified at 15 U.S.C.A. § 78j, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[23] *See also In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 990 (8th Cir. 2006) ("'deceptive' conduct involves either a misstatement or a failure to disclose by one who has a duty to disclose.") (*citing Central Bank*); *Regents of the University of California et al. v. Credit Suisse First Boston (USA), Inc. et al (Enron Sec. Litig.)*, --F.3d --, 2007 WL 816518 (5th Cir. March 19, 2007) (same).

"[m]anipulation is virtually a term of art when used in connection with securities markets. The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Santa Fe*, 430 U.S. at 476. Similarly, in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976), cited in *Central Bank*, the Supreme Court stated that "[10(b)'s] [u]se of the word 'manipulative' is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."

In *In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006), the Eighth Circuit expressly relied on the Supreme Court's careful reading of "manipulative" to reject the application of scheme liability. In *Charter Communications*, plaintiffs had alleged that certain outside vendors had engaged in sham transactions with Charter Communications, a cable TV company, the result of which was the overstatement of Charter's financial position and corresponding losses to investors. Because the vendors had not made any of the allegedly fraudulent financial misstatements, plaintiffs alleged that the vendors were liable for engaging in a manipulative scheme. The Eighth Circuit, however, ruled that "manipulative" as used in Section 10(b) "has the limited contextual meaning ascribed in *Santa Fe*." *Charter Communications*, 443 F.3d at 992. Accordingly, the court ruled that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5." *Id.* Because the vendors had not allegedly engaged in any such trading practices, scheme liability could not lie. *Id.*

More recently, the Fifth Circuit followed the Eighth Circuit's reading of "manipulative" to include only instances in which the defendants "act[s] directly in the market for the relevant security." *Regents of the University of California et al. v. Credit Suisse First Boston (USA), Inc. et al (Enron Sec. Litig.)*, --F.3d --, 2007 WL 816518 (5th Cir. March 19, 2007).[24] There, the Fifth Circuit took and decided a Rule 23(f) petition on class certification brought by three non-settling banks in the *Enron Securities Litigation*. Plaintiffs alleged that the banks had knowingly engaged in a scheme to defraud pursuant to Rule 10b-5(a) and (c) by entering into transactions with Enron such as purchasing Enron interests in various enterprises with Enron's guarantee that Enron would repurchase the same interests within months at a higher price, all so that Enron could take liabilities off its books temporarily and book revenue from the transactions when it was actually incurring debt. The Fifth Circuit utilized its discretionary review of the district court's class certification ruling to hold that the banks faced no liability because they themselves made no public misrepresentations, had no duty to disclose under *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), and thus did not engage in any deceptive act, nor did they engage in any manipulative act as that term is narrowly defined in the Supreme Court *Santa Fe* decision and by the Eighth Circuit in *In re Charter Communications*.

[24] The Fifth Circuit adopted the definition of manipulation gives by an earlier district court decision as follows: "'practices in the marketplace which have the effect of either creating the false impression that certain market activity is occurring when in fact such activity is unrelated to actual supply and demand or tampering with the price itself are manipulative.'" *Regents of the Univ. of Calif.*, 2007 WL 816518, *13 (*quoting Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979).

Certain district courts, including *Global Crossing*, 322 F. Supp. 2d at 336-37, have rejected this reading of "manipulative." Here, courts point to *SEC v. Zandford*, 535 U.S. 813 (2002), in which the Supreme Court stated that Section 10(b) and Rule 10b-5 are intended to be read "flexibly, not technically and restrictively." *Id.* at 821. In *Zandford*, the court considered the "in connection with the purchase or sale of any security" requirement and affirmed the use of Section 10(b) by the SEC against a stock broker who stole client assets, concluding that the broker's actions in establishing phony escrow accounts and using the proceeds for his own purposes was an unlawful scheme in connection with the purchase or sale of securities. While the *Zandford* court did not address the issue, the broker's acts presumably constituted a "manipulative" contrivance (rather than a misrepresentation) and, accordingly, *Zandford* may be held out as authority for the proposition that manipulative acts may be broadly defined. To be sure, however, the business of the accused in *Zandford* was clearly in the securities marketplace in contrast to any non-representational activity of an auditor such as allegedly structuring an accounting transaction. The accused took orders and executed stock trades for clients, perhaps sometimes after making portfolio recommendations. Presumably, the Supreme Court in *Charter Communications* will rule on which view of "manipulative" is the correct one.

As an aside, other courts seem to have applied scheme liability without agonizing over the definition of "manipulative." They have done so by either charting their own definitions of deceptive devices or by referring to Rule 10b-5 without recognizing that it can be no broader than the statute it was promulgated under, Section 10(b).[25] For example, in *Simpson v. AOL Time Warner*, 452 F.3d 1040 (9th Cir. 2006), the Ninth Circuit, arguably in defiance of various aspects of *Central Bank*, upheld the use of scheme liability reasoning that where a defendant's conduct has the principal purpose and effect of creating a false appearance of fact in furtherance of a scheme to defraud, that conduct amounts to "a deceptive device" within the meaning of Section 10(b). *Id.* at 1050.

b. Reliance and Causation

The scope of reliance in Rule 10b-5 (a) and (c) cases also remains unresolved. Reliance in Section 10(b) cases, often referred to as "transaction causation," requires a showing that plaintiffs have relied upon the alleged misrepresentation and would not have bought the security in its absence. *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S.Ct. 1627, 1631 (2005) (relying on common law foundation of Section 10(b)). *Central Bank* drew the lines it did because allowing aiding and abetting liability would dispense with the reliance requirement. 511 U.S. at 180. At least it would do so in misstatement cases. Reliance is a necessary element of any claim under Section 10(b), including those for market manipulation. *Haberman v. Murchison*, 468 F.2d 1305, 1311 (2nd Cir. 1972) ("Section 10(b) and Rule 10b-5 afford protection only to those who actually purchase or sell securities to their loss in reliance upon the withholding or

[25] *See, e.g., Regents of the University of California et al. v. Credit Suisse First Boston (USA), Inc. et al (Enron Sec. Litig.)*, --F.3d --, 2007 WL 816518 (5th Cir. March 19, 2007) ("The appropriate starting point is the text of the statute. Decisions interpreting the statutory text place a limit on the possible definitions that can be ascribed to the words contained in the SEC's rule promulgated thereunder. It is by losing sight of the limits that the statute places on the rule . . .that the district court and likeminded courts have gone awry.") (citations omitted).

misrepresentation of material information or other manipulative or deceptive devices.”).[26] Recent cases have struggled with the exact scope of reliance in Rule 10b-5 (a) and (c) cases. The issue generally faced by the courts is “[h]ow direct a relationship must there be between a ‘primary’ violator’s conduct and a plaintiff’s losses?”[27]

The Fifth Circuit in the recent case, *Regents of the University of California/Enron Sec. Litig.*, placed the reliance element at the heart of its decision in finding scheme liability incompatible with Section 10(b). *See id.*, 2007 WL 816518, at n.16 (aiding and abetting liability as barred by *Central Bank* would permit plaintiffs to “‘circumvent the reliance requirement,’ because a ‘defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions’”) (quoting *Central Bank*, 511 U.S. at 180).

In *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161 (D. Mass. 2003), however, the court set forth the reliance element as follows:

> A closely related issue is the requirement that plaintiffs demonstrate reliance on the manipulative or deceptive device. Consistent with its interpretation of the reach of § 10(b) and Rule 10b-5, the Court holds that plaintiffs can satisfy the reliance requirement by alleging facts sufficient to show (1) that defendants substantially participated in a fraudulent scheme; and (2) when the scheme is viewed as a whole, the plaintiffs relied on it.

Id., 236 F. Supp. 2d at 174. The *Lernout & Hauspie* court also ruled that “the better reading of § 10(b) and Rule 10b-5 is that they impose primary liability on any person who substantially participates in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device (like the creation or financing of a sham entity) intended to mislead investors, even if a material misstatement by another person creates the nexus between the scheme and the securities market.” *Id.* at 173.

The District Court for the Southern District of New York recently set an arguably more relaxed reliance requirement in the context of scheme liability. *See In re Initial Public Offering Sec. Litig.*, 241 F. Supp. 2d 281, 296 (S.D.N.Y. 2003) (“Plaintiffs must plead with particularity the manipulative scheme itself, the intent to defraud the investing public, reliance on the integrity of the market (i.e., that they believed it was not manipulated) and resulting damages.”); *see also Scone Investments, L.P. v. American Third Market Corp.*, 1998 WL 205338, *5 (S.D.N.Y. Apr. 28, 1998) (“Market manipulation schemes which are intended to distort the price of a security, if successful, necessarily defraud investors who purchase the security in reliance on the market's integrity. Absent the fraud on the market theory, the parties injured by such manipulative schemes could not plead the necessary element of reliance.”).

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[26] In cases alleging material omission or nondisclosure, as opposed to affirmative material misrepresentation, a plaintiff need not show reliance in order to show transaction causation but must still show that the facts in question were material “in the sense that a reasonable investigator might have considered them important” in making his investment decisions. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-154 (1972).

[27] Harbert S. Washer and Adam S. Hakki, “‘Scheme’ Theory Evolves Under Rule 10b-5, New York Law Journal, December 19, 2005, at 14.

Commentary has noted that these cases apply a "loose" reliance requirement arguably in conflict with the *Central Bank* mandate that secondary actor liability satisfy all of the requirements for primary liability, including reliance.[28] The Supreme Court may provide guidance here as well in *Charter Communications*.

c. End-Running *Central Bank*

At its core, the problem with scheme liability, when it is imposed on secondary actors like auditors in securities fraud cases, is that it conflicts with, or seemingly attempts to end-run, Section 10(b), Supreme Court precedent generally and *Central Bank's* preclusion of aiding and abetting liability in particular. The Supreme Court has been clear that Section 10(b) is an anti-fraud statute with common law roots (*see Dura*, 125 S.Ct. at 1632) and that courts cannot "add a gloss to the operative language" of the statute to define "fraud" broadly. *Santa Fe*, 430 U.S. at 472 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. at 199). Except in the limited circumstances of narrow market manipulation, Section 10(b) only prohibits the making of a misrepresentation or omission and aiding and abetting fraud is simply not prohibited by the statute.

A review of the recent "scheme liability" cases reveals that they all indeed involve fraud, that is, they all involve misrepresentation to the market, usually by the company. Indeed, it is only through the market misrepresentation that the stock price gains the necessary predicate for subsequent damages: over-inflation. To tag secondary actors with primary liability for "scheming" with the company in carrying out its fraudulent misrepresentations to the market is nothing more than saying they aided and abetted the company in making its misrepresentation. Simply re-labeling "aiding and abetting fraud" as "scheming to defraud" in order to circumvent the limitations of Section 10(b), should not carry the day in the face of *Central Bank*, *Hochfelder*, *Santa Fe* and *Dura*.

One simple solution is to recognize that when the core allegation is one of misrepresentation to the market, scheme liability cannot simultaneously be pled. *See Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 177 (2d Cir. 2005) ("plaintiffs cast their claims in terms of market manipulation, pursuant to Rule 10b-5(a) and (c). We hold that where the sole basis for such claims is alleged misrepresentations or omissions, plaintiffs have not made out a market manipulation claim under Rule 10b-5(a) and (c).").[29]

Thus, one must seriously ask how scheme liability can coexist in a securities case alleging at its core that material misrepresentations were made to the investing public. Perhaps

[28] *See* Washer and Hakki, *supra* note 27, at 14 (*quoting Central Bank*).

[29] Even the courts that have allowed broad scheme liability to proceed in securities fraud cases have noted this problem. *See Lernout & Hauspie*, 230 F. Supp. 2d at 175 (refusing to allow liability under subsections (a) and (c), as opposed to (b), to proceed against KPMG for its role in allegedly making materially false statements as "subsections (a) and (c) of Rule 10b-5 do not create a short cut to circumvent *Central Bank's* limitations on liability for a secondary actor's involvement in preparing misleading documents."); *In re Parmalat Securities Litigation*, 376 F. Supp. 2d 472, 503 (S.D.N.Y. 2005) ("This analysis is not a back door into liability for those who help others make a false statement or omission in violation of subsection (b) of Rule 10b-5.").

alleging scheme liability in a misrepresentation case should be viewed for what it is -- an attempt to resurrect aiding and abetting liability.[30]

C. **One Firm Theories: Single Entity, Agency, Alter Ego and Control Person Liability**

Another issue of interest in current securities litigation involving auditors is the propriety of bringing in entities related to the auditor that allegedly issued misleading audit opinions. Commonly, these attempts involve moves to sue international umbrella organizations of the largest firms even though they are distinct legal entities that have had no real role in the auditing work at issue. Plaintiffs have recently succeeded to varying degrees in their attempts to rope in these international umbrella organizations, and occasionally other member firms, for the alleged misdeeds of a particular member firm. Plaintiffs have employed a variety of theories in this endeavor.

1. Use of Agency Theory to Snare International Umbrella Organizations and Member Firms

In *In re Parmalat Sec. Litig.*, 375 F. Supp. 2d 278 (S.D.N.Y. 2005), plaintiffs successfully alleged agency liability among various related auditing entities.[31] While Deloitte & Touche Italy and Grant Thornton Italy had performed the allegedly fraudulent audits of Parmalat's financial statements, plaintiff pled that the firms had served respectively as the "agents" of Deloitte's and Grant Thornton's international umbrella organizations respectively, Deloitte Touche Tohmatsu (DTT) and Grant Thornton International (GTI). In allowing plaintiffs' agency theories to survive a motion to dismiss, the court first explained that a principal will be vicariously liable for the acts of its agent and that an agency relationship will exist when there is agreement between the principal and the agent that the agent will act for the principal and the principal retains a degree of control over the agent. 375 F. Supp. 2d at 290.[32]

Turning to the facts alleged, the court concluded that because plaintiffs had alleged that DTT had intervened and "took actions in directing - or directing the removal of - auditors on the Parmalat audit" and because an audit partner with Deloitte Italy had sought direction and help in connection with the audits in question from the Deloitte umbrella organization, "it could be inferred that DTT was in ultimate control of the audit." *Id.* at 294-95. The court also noted that the logo of DTT appeared on the audit reports issued by Deloitte Italy. The court concluded

[30] The *Global* Crossing court's attempt to square scheme liability in a misrepresentation case with *Central Bank* seems wholly unsatisfactory. *Global Crossing*, 322 F. Supp. 2d at 337 n.17 (Andersen "may not be held liable for any of the individual unaudited *statements* made by AGC under Rule 10b-5(b), although it may be held liable for the fraudulent *scheme* behind them.").

[31] Demonstrating that such attempts have generally failed, defendants in *Parmalat* cited at least ten cases in which courts rejected a plaintiff's allegation of an agency relationship between an accounting firm and its international umbrella organization.

[32] The court also ruled that because the allegation of agency "is not so closely intertwined with the claim of securities fraud that it is a circumstance of the fraud itself" it need not be pled with particularity and the notice pleading standards of Rule 8, rather than the more stringent requirements of Rule 9(b), apply. *Parmalat*, 375 F. Supp. 2d at 291.

these allegations were enough to allow the agency claim to proceed. With respect to the Grant Thornton firms, the court held that plaintiffs' allegations that GTI had investigated and disciplined the Italian member firm and ultimately expelled it from the group "suggests that it had the power to direct the policies and practices of that firm - a defining characteristic of agency" and, accordingly, the court found an agency relationship between Grant Thornton Italy and GTI had been adequately alleged. *Id.* at 300-01.

In contrast, in *Lernout & Hauspie*, the court rejected plaintiffs' attempts to impose single entity liability on KPMG's various world entities noting that, while the theory may be legally viable, it was not adequately alleged. KPMG's web-site specifically indicated that the various entities were separate bodies and, accordingly, there was no basis for treating the various international entities as one legal entity for liability purposes. 230 F. Supp. 2d at 170-73.

Similarly, in *WorldCom,* plaintiffs tried to snare Andersen Worldwide SC ("AWSC"), a Swiss societé cooperative that served as the "umbrella organization" for Andersen member firms, on account of the US firm, Arthur Andersen LLP's, alleged fraudulent misstatements in connection with its audits of WorldCom's financial statements. *In re WorldCom, Inc. Sec. Litig.*, 2003 U.S. Dist. LEXIS 10863, 33-34 (S.D.N.Y. June 25, 2003). The international umbrella organization was not alleged itself to have actively participated in any way in the auditing or fraud. The court explained that while agency theory may be used to assert liability for a Section 10(b) claim, the complaint did not allege that Andersen acted as an agent of AWSC, the umbrella organization, when it conducted the WorldCom audits.

In yet another case, plaintiffs were unable to establish an agency relationship between KPMG US and KPMG Bermuda. *Schnall v. Annuity and Life RE (Holdings), Ltd.*, 2006 WL 2331138 (D. Conn. Aug. 10, 2006). In *Schnall*, KPMG Bermuda had signed the allegedly misleading audit opinion. In addition to suing KPMG Bermuda, plaintiffs attempted to sue KPMG US on a variety of theories including an agency theory pursuant to which KPMG Bermuda was supposedly acting as KPMG US's "agent" when it signed the audit opinion. The court held that plaintiffs' allegations that the two firms collaborated on the audit were insufficient to find an agency relationship under classic agency law, which requires the allegation that one firm had the authority to bind the other or that one agreed to act on behalf of the other person and subject to his control. *Id*., 2006 WL 2331138, at *5-6.

2. Use of Alter Ego Theory to Bring In Member Firms

In *Parmalat*, having alleged that Deloitte Italy and Grant Thornton Italy firms were the agents of their international umbrella organizations, plaintiffs attempted to assert further that Deloitte's and Grant Thornton's US firms were sufficiently large and so dominated and controlled the international umbrella organizations that they were in fact the organizations' alter egos and therefore liable to the same extent as the umbrella organizations for the Italian firms' misdeeds. *Parmalat*, 375 F. Supp. 2d at 291; 296-97; 301-02. Plaintiffs alleged little more than that Deloitte's US firm shared marketing materials and executives with the international organization, and that Grant Thornton US earned 25% of the global revenues and thus "was the proverbial thousand pound gorilla, able to use its size to get what it wanted." *Id.* at 301-02. The *Parmalat* court rejected plaintiffs' attempt to stitch together an alter ego theory for use in extending liability from the international organization to the US firms.

Interestingly, in a related common law malpractice and fraud action brought by Parmalat's bankruptcy trustee against its auditors, the court concluded that, on the basis of an amended pleading, plaintiff had adequately alleged that Grant Thornton US controlled GTI, which in turn was the agency instrument through which Grant Thornton US controlled the various worldwide member firms, including Grant Thornton Italy. Thus, wrote the court, Grant Thornton US can be held liable for Grant Thornton Italy's alleged misdeeds, if they are proven. *In re Parmalat Sec. Litig., Bondi v. Grant Thornton Int'l et al.*, 421 F. Supp. 2d 703 (S.D.N.Y. 2006).

3. Use of Control Person Liability to Bring in Member Firms

In *In re Parmalat*, while the court found that plaintiffs had failed to allege that the US firms were the alter egos of their international umbrella organizations, the court nevertheless found that the same allegations, namely that Deloitte & Touche LLP (US)'s top executives held the top two positions at Deloitte's international organization and that at least one of those executives was involved in the Parmalat audit, were sufficient for motion to dismiss purposes to give rise to an inference that Deloitte &Touche LLP (US) controlled the Deloitte international organization, DTT, for control person liability purposes under Section 20(a). *Parmalat*, 375 F. Supp. 2d at 311. By this theory then, Deloitte & Touche LLP (US) could be held responsible not only for DTT's liability, but also for that of DTT's "agent," Deloitte & Touche Italy. In contrast, the court held in the same opinion that insufficient facts had been pled for control person liability with respect to Grant Thornton US's control over GTI where the only "non-conclusory allegations" of control alleged were that Grant Thornton US made up a relatively large portion of GTI and had access to the international organization's books and records. *Id.*

In *Schnall v. Annuity and Life RE (Holdings), Ltd.*, 2006 WL 2331138 (D. Conn. Aug. 10, 2006), the court reached a contrary result. There, plaintiffs alleged that KPMG US controlled KPMG Bermuda, the entity that actually signed the allegedly misleading audit opinion, and therefore should face Section 20(a) control person liability for KPMG Bermuda's allegedly misleading statements. The court ruled that in order to make out control person liability, plaintiffs must allege that the status of the controlling entity gave it general power over the controlled entity and that the controlling entity did, in fact, exercise that power. *Id.*, 2006 WL 2331138, at *7 (*citing Lernout & Hauspie Securities Litigation*, 230 F. Supp. 2d 152, 175 (D. Mass. 2002). The court further ruled that allegations of collaboration on an audit and the joint defense of that audit do not meet these minimum requirements. *Id.*

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