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AUDITOR LIABILITY IN SECURITIES LITIGATION FROM A DEFENSE PERSPECTIVE

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I. INTRODUCTION

Despite the fact that securities fraud lawsuits involving auditors are said to be relatively few in number as a percentage of total new filings and new filings are below the historical average, auditors often come to be added as defendants, particularly in high-profile cases.[1] In the past few years, for example, auditors have been named as parties in the five proceedings with the largest total dollar value settlements to date -- *Enron*, *WorldCom*, *Cendant*, *Tyco* and *AOL Time Warner*[2] -- and in several other well-known actions including *Global Crossing*, *Parmalat* and *Delphi*. With the majority of all cases historically 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 understanding and educating the court regarding the role of the auditor, namely 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, 2007: A Year in Review," at 5, new securities fraud class action filings for 2007 rose to 166 from the 2006 low of 116 new cases but were still below historical 10-year average of 194. Some, including Stanford's Professor Joseph Grundfest, suggest that the decline in new filings may be attributed to "less fraud" resulting from factors including enhanced monitoring by auditors. *Id.* at 4. Cornerstone also reported that auditors were named as defendants in only two new securities fraud class actions filed in 2007 (or one percent of new filings) and in only 2% of new cases filed in 2006 (and 3% of new cases filed in 2005). *Id.* at 20. One must add to these figures cases in which auditors are named as defendants in amended complaints after the initial filings, a not infrequent event. Cornerstone's study of class action settlements from 2007 notes that accountants have been involved in just under 20% of all post-PSLRA settlements through 2007. Cornerstone Research's "Securities Class Action Settlements," 2007 Review and Analysis," at 8.

[2] Nera Economic Consulting, "2007 Year End Update, Recent Trends in Shareholder Class Action Litigation: Filings Return to 2005 Levels as Subprime Cases Take Off; Average Settlements Hit New High," December 2007, at 11 (listing top ten shareholder class action settlements, in dollar terms, as of December 2007).

[3] Cornerstone Research's "Securities Class Action Case Filings 2007: A Year in Review," at 20, reports that 92% of filings in 2007 alleged misrepresentations in financial documents (with the same 92% figure reported for 2006 and up from 88% in 2005 and 78% in 2004). Cornerstone's "Securities Class Action Case Filings, 2007: A Year in Review," at 20, reports that 42% of securities complaints filed in 2007 alleged specific accounting irregularities (down from 66% of all complaints in 2006) and Cornerstone's "Securities Class Action Settlements" study, at 8, reports that more than 55% of cases settled through 2007 have historically included accounting issue allegations.

II. THE ROLE OF THE AUDITOR

Counsel litigating securities cases involving auditors would be wise always to be mindful of the role of the auditor. The auditor's potential liability in securities actions generally is for alleged misrepresentation stemming from his audit opinion, included in the financial section of a reporting company's annual report (Form 10-K). It does not stem from the reporting company's financial statements themselves, for which management alone takes responsibility and as to which the auditor declares his independence.

Putting aside theories of liability for secondary actors discussed later in this article, the auditor is not liable for misstatements appearing in the company's unaudited interim (Form 10-Q) financial reports or in related company announcements, although plaintiffs often assert otherwise. The simple reason is that the auditor rarely, if ever makes public representations regarding those interim financial statements. Unless the auditor undertakes to review and issue a published report on the interim financial statements, the auditor is only liable for his published audit reports on the company's annual financial statements, even though federal regulations (17 C.F.R. § 210.10-01(d)) require the company's auditor to "review" quarterly financial statements. The Second Circuit recently reaffirmed this rule in *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)).

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 assert that it is the auditor 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 . . . [the auditor] 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) (auditor "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 paradoxically issue an independent opinion on those statements. As the standard audit opinion makes clear, management prepares and takes responsibility for its financial statements. The auditor engaged by management conducts audit procedures in accordance with generally accepted auditing standards (GAAS) in order to provide assurance regarding whether the company's financial statements, taken as a whole, fairly present in all material respects in accordance with generally accepted accounting principles (GAAP) the company's financial position as of a given date (generally a fiscal year end date) and the results of its operations and cash flows for the period then ending. The Supreme Court has summarized part of the process as follows:

> 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). *See also Bily v. Arthur Young & Co.*, 834 P.2d 745, 750 (Cal. 1992) ("The end product of an audit is the audit report or opinion . . . [on] the specific client-prepared financial statements.").

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, as well as the nature of the opinion. The auditor's report generally closely follows a prescribed form. The form of the standard audit opinion is as follows:

<u>Independent Auditor's Report</u>

> 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).[4] Those standards

[4] Prior to enactment and implementation of the Sarbanes-Oxley Act of 2002, audit opinions concerning the financial statements of public companies (issuers) recited that the audit was conducted in accordance with generally accepted auditing standards (GAAS). Section 103 of the Sarbanes-Oxley Act mandated that the newly-formed Public Company Accounting Oversight Board (PCAOB) set auditing standards and required that public company auditors of issuers adhere to those standards. 15 U.S.C. § 7213. In 2003, the PCAOB adopted the auditing standards issued by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA), as those standards existed on April 16, 2003. *See* PCAOB Release No. 2003-006, Establishment of Interim Auditing Standards. Since then, the PCAOB has issued its own Auditing Standard No. 1 - References in Auditors' Reports to the Standards of the PCAOB. Accordingly, audit opinions regarding the financial statements of SEC registrants now recite that audits are conducted in accordance with the standards of the PCAOB . Three additional PCAOB Auditing Standards are presently in effect: No. 3 (Audit

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 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.[5]

It is worthwhile educating the court from the outset as to what the auditor actually undertakes to do and then reminding 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

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Documentation), No. 4 (Reporting on Whether a Previously Reported Material Weakness Continues to Exist), and No. 5 (An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements), which superseded No. 2 (An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements). Another standard has been adopted by the PCAOB and awaits approval by the SEC: No. 6 (Evaluating Consistency of Financial Statements).

[5] Section 404 of the Sarbanes-Oxley Act of 2002 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.

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 his undertaking -- an audit in accordance with GAAS -- or, at least in the Section 10(b) context, 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 may favorably impact litigation.

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

In *Deephaven Private Placement Trading, Ltd. v. Grant Thornton*, 454 F.3d 1168 (10th Cir. 2006), plaintiffs brought suit against Grant Thornton under Section 18(a) of the Securities Exchange Act of 1934 on account of its audit opinions on the financial statements of Daw Technologies, Inc. Section 18, infrequently used perhaps because reliance must be proven on an individualized basis, and when added to a class action, creates issues regarding allocation of settlement funds, allows suits for misstatements made in certain SEC filings.[6]

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 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

[6] 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. Additionally, as per SEC regulations (17 CFR § 240.13a-13(d)), there can be no Section 18 liability for Forms 10-Q. *In re Stone & Webster, Inc., Sec. Litig.*, 253 F. Supp. 2d 102, 135 (D. Mass. 2003).

> 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 then 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: 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.[7]

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 GAAP-related 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 likelihood of a misstatement based on the first alternate prong noted in *Deephaven*, that of the auditor's not actually forming his opinion is remote at best, but logically it should be considered. The battleground in the usual litigation involving auditors is the second prong, namely the auditor's basis for opining as he did). The *Deephaven* court also addressed 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.[8]

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[7] 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.

[8] While there are no reported cases directly applying the principles enunciated in *Deephaven* (or *Virginia* Bankshares) to a Section 11 claim against an auditor, there is no reason logically why the argument cannot be made. Under Section 11, an auditor is only liable for those portions of the registration statement that purport to have been prepared or certified by him. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386 n.22 (1983). Generally, the only material included in a registration statement that purports to be prepared or certified by the company's auditors is the auditor's audit opinion itself. *See In re AOL Time Warner, Inc. Sec. Litig.*, 503 F. Supp. 2d 666 (S.D.N.Y. 2007) (under Section 11, "liability only attaches to an auditor for its certified audit opinions."). Thus, to assert Section 11 liability as to an auditor, it would follow that a plaintiff would need to allege that the audit opinion is

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 Pharmaceuticals, 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 company financial statements for which statements company management alone assumes responsibility, the following question arises under *Dura*: what constitutes a sufficient "corrective disclosure" to trigger damages attributable to the auditor's opinion? Certainly, courts are beginning to understand the need under *Dura* for a sufficient connection between the auditor's alleged misrepresentation and the loss shareholders allege. *Lattanzio v. Deloitte & Touche LLP (Warnaco Sec. Litig.)*, 476 F.3d 147, 154-156 (2d Cir. 2007) (loss causation not adequately alleged against auditor; company's bankruptcy not a corrective disclosure or within "zone of risk" of auditor's alleged misrepresentation that he conducted his audit in accordance with accepted principles); *Tricontinental Industries, Ltd. v. PricewaterhouseCoopers LLP*, 475 F.3d 824, 842-43 (7th Cir. 2007) (loss causation not adequately alleged where alleged misrepresentation concerned 1997 audit opinion and alleged corrective disclosure related to 1998 and 1999 audited financial statements and bankruptcy; "Tricontinental had to allege that PwC's 1997 audit contained a material misrepresentation which caused Tricontinental to suffer a loss when that material misrepresentation 'became generally known;'" plaintiff did not identify any statement that made "generally known" any problems or irregularities in the 1997 audited financial statements).

Generally, practitioners and courts should ask whether the purported corrective disclosure actually bears on the auditor's alleged misstatement, i.e., his opinion that the challenged financial statements are presented fairly, in all material respects, in conformity with GAAP. (It is the GAAP opinion regarding the defendant company's financials that contributes to the inflated value of the company's stock price; the auditor's representation of having performed a GAAS audit does not, absent the GAAP opinion, itself enhance the perceived value of a company's performance and the company's financial position). More

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false and misleading. To assert an opinion is false, plaintiff must allege and demonstrate that the opinion is subjectively and objectively false. *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1095-96 (1991). In a series of Section 11 "fair value" opinion cases, courts have held that for opinions to qualify as misleading under Section 11, plaintiff must allege the opinions are objectively and subjectively false. *In re Harmonic, Inc, Securities Litigation*, 00-2287, 2006 WL 3591148, *16 (N.D.Cal. Dec. 11, 2006) ("While an 'opinion' can be considered a 'fact' for purposes of § 11(a), a plaintiff must show that the defendant did not believe in the statement made."); *Bond Opportunity Fund v. Unilab Corp.*, No 99-11074, 2003 WL 21058251, *5 (S.D.N.Y. May 9, 2003) ("Plaintiffs who charge that a statement of opinion, including a fairness opinion, is materially misleading, must allege 'with particularity' 'provable facts' to demonstrate that the statement of opinion is both objectively and subjectively false."); *In re Global Crossing, Ltd. Securities Litigation*, 313 F. Supp. 2d 189, 210 (S.D.N.Y. 2003) (dismissing Section 11 claim against issuers of "fair value" opinion for failure to allege that defendant was aware that its purported opinion about the fairness of the transaction was wrong").

specifically, in the typical auditor case, practitioners and courts should ask whether a corrective disclosure concerning the company or its financial statements is sufficient to satisfy loss causation as to an audit opinion, or whether a corrective disclosure for *Dura* purposes as to the auditor must speak to or bear on the audit opinion itself, calling into question both its objective and subjective veracity.

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, 1095-96 (1991), to establish the falsity of an opinion in the fraud context, a plaintiff must establish its subjective and objective falsity. *In re Credit Suisse First Boston Corp. (Agilent Technologies Sec. Litig.)*, 431 F.3d 36 (1st Cir. 2005) (dismissing Section 10(b) claim against analysts due to failure to meet PSLRA pleading requirements in regard to subjective falsity of opinion and scienter; thus no need to address other issues such as objective falsity) (*citing Virginia Bankshares*); *In re JP Morgan Chase & Co. Securities Litigation*, 2007 WL 4531794, *10 (N.D. Ill. Dec. 18, 2007) ("Statements of opinion or belief are actionable only if they are both objectively and subjectively false.") (*citing Virginia Bankshares*). 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 opinion); *In re Scottish RE Group Sec. Litig.*, 524 F. Supp. 2d 370, 398 (S.D.N.Y. 2007) (applying *Virginia Bankshares* to audit 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), an actionable audit opinion requires disclosure of not just its objective falsity, but also its subjective falsity.

Again, while no reported decision has directly reached this holding, a parallel strain of case law suggests the potential for requiring disclosure of the subjective falsity of an audit opinion to make it actionable. 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.”).

Absent from the analyst opinion, however, is a stated basis for the opinion that rests on well-articulated professional standards, such as those on which an audit opinion rests, i.e., GAAS. While one must recognize this distinction, it also is the case that it is not to be expected that the auditor’s representation of performance of a GAAS audit will actually have created any significant stock price inflation -- in contrast to the potential for inflation that rests with management’s representation of their company’s financials conforming with GAAP and the auditor’s confirmatory opinion. Thus, if there is a corrective disclosure causing stock price deflation, it should concern GAAP and, as to that, the auditor has opined and not made the factual representations made by management. Accordingly, one is left to ask whether there is any reasoned basis allowing one to exclude application of the aforementioned analyst loss causation line of cases, requiring disclosure of objective and subjective falsity, when considering the defendant auditor.

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 who bring 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). At the pleading stage, plaintiffs must “state with particularity facts giving rise to a strong inference that the defendant acted with [scienter].” 15 U. S. C. §78u–4(b)(2). In assessing whether the strong inference requirement is met, the court, viewing the complaint as a whole, engages in a comparative evaluation of the inferences favorable to plaintiff and competing inferences of nonculpability drawn from the facts alleged. The strong inference standard is met only when the inference of fraudulent intent is cogent and at least as strong as nonculpable explanations for the defendant’s conduct. *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007). A similar comparative evaluation of inferences of scienter takes place post-pleading, including at trial.[9]

[9] Prior to *Tellabs*, there was some uncertainty regarding whether the strong inference standards applied post-pleading. *Compare Geffon v. Micrion Corp.*, 249 F.3d 29, 36 (1st Cir. 2001) (PSLRA’s heightened pleading standards apply at summary judgment stage) and *Tse v. Ventana Med. Sys., Inc.*, 123 F. Supp. 2d 213, 225-26 (D. Del. 2000) (same) *with 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) and *In re Bristol-Myers Squibb Securities Litigation*, 2005 WL 2007004, *16 (D.N.J. Aug 17, 2005) (similar). *Tellabs* clarified that at trial plaintiff must establish scienter by a preponderance of the evidence by proving that it is more likely than not that the defendant acted with scienter. *Tellabs*, 127 S. Ct. 2513.

While the effect of *Tellabs* on preexisting standards differs from circuit to circuit, "the decisions to date from all circuits since *Tellabs* suggest that courts are applying a more stringent pleading standard." J.P. Stigi and M. White, "Courts interpret 'Tellabs'" NATIONAL LAW JOURNAL, March 17, 2008; *see also In re Bisys Sec. Litig.*, 496 F. Supp. 2d 384, 386 n.1 (S.D.N.Y. 2007) (*Tellabs* raised the bar for plaintiffs to state a claim, including with respect to auditors; "If anything, the law is now more favorable to [the auditor] than it was when Judge Kaplan made his decision"). Further, while the general scienter standard developed by the courts, including the *Tellabs* court, applies equally to issuer defendants, auditor defendants and other secondary actors alike, *Tellabs's* stress on weighing competing inferences may tilt decisions in favor of auditors in cases when counsel can underscore that the issues involve matters of judgment and application of complex accounting rules as to which reasonable professionals may reach different results.

A. <u>Scienter Standards as to Auditor Defendants Are Especially Stringent</u>

Recognizing 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 In re Scottish RE Group Sec. Litig.*, 524 F.Supp.2d 370, 385 (S.D.N.Y. 2007) ("there is a high standard for pleading auditor scienter"; post-*Tellabs* decision dismissing complaint as to auditor on scienter grounds (and upholding complaint as to other defendants)); *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)); *In re National Century Financial Ent., Inc.*, 03-md-1565, 2007 WL 2331929, *6 (S.D. Ohio Aug. 13, 2007) ("'The meaning of recklessness in securities fraud cases is especially stringent when the claim is brought against an outside auditor.'").

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); *see also 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"); *In re Scottish RE Group Sec. Litig.*, 524 F.Supp.2d 370, 398 (S.D.N.Y. 2007) (Plaintiffs must allege that "'[t]he 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 ....'") (citation omitted).

B. "Red Flags" and Auditor Scienter

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*, 392 F.3d at 230 ("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 concerns 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.[10]

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, *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*, 2007 WL 430731, *15-20 (M.D. Fla. Feb 03, 2007) (similar); *Grand Lodge of Pa. v. Peters*, 07-479, 2008 WL 697340, *6 (M.D.Fla. March 13, 2008) (similar).

Similarly, a plaintiff who alleges that the auditor violated GAAS in the conduct of his 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,

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

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 [the auditor] 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 [the auditor]'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," the 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 auditor finding scienter adequately alleged).

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)); *see also 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*, 392 F.3d at 230 ("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.[11] 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)

[11] 42% of new securities case filings in 2007 reportedly contained allegations of GAAP violations (down from 66% of new filings in 2006 and 44% in 2005). Cornerstone Research, "Securities Class Action Case Filings 2007: A Year in Review," at 20.

(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 (N.D. Cal. April 2, 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. <u>Size of GAAP Violations as Evidence of Scienter</u>

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) (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*, 392 F.3d at 231-32 ("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, *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. <u>Relevance of Professional Fees</u>

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."); *Lewis v. Straka*, No. 05-1008, 2007 WL 2332421, *4 (E.D.Wis. Aug. 13, 2007) (rejecting plaintiff's argument that fees are evidence of scienter reasoning that "auditor's short term gain in auditing fees derived from improperly certifying financial statements would be outweighed by its long-term interest in maintaining a solid reputation as an honest accounting firm."); *In re Stone & Webster*, 414 F.3d at 215 (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); *but see 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 himself is alleged to have engaged in his 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. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994), seemingly put an end to "aiding and abetting" liability for auditors and other secondary actors. Other 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. The Supreme Court in the recent case of *Stoneridge Inv. Partners LLC v. Scientific-Atlanta Inc.*, 128 S. Ct. 761 (2008), had the opportunity to address matters of this kind, but in the end, as discussed below, drew a few lines without expounding in depth on liability for secondary actors. The *Stoneridge* court affirmed the core *Central Bank* holding that "[t]he § 10(b) implied private right of action does not extend to aiders and abettors" (128 S. Ct. at 769) and emphasized the related principle that reliance is an indispensable element of all Section 10(b) cases. Of particular interest, the Supreme Court observed that not just material misstatements and omissions can give rise to Section 10(b) claims; deceptive acts (presumably aside from "manipulative" market activity) can also, but it stopped there and gave no further guidance. *Stoneridge*, 128 S.Ct. at 769.

Various theories that have been tried out against auditors in recent cases are set forth and discussed below.

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 annual 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 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 have 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, no matter how substantial that aid may be." *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998).[12] 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 his 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*).

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

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[12] *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*, 392 F.3d at 235 ("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).

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).[13] 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 *ZZZZ Best*, in seeming contravention of *Central Bank*, 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.

To the extent the Ninth Circuit test dispenses with reliance, it is in conflict with *Central Bank* and overruled by the Supreme Court's recent *Stoneridge* decision, which affirmed that "[r]eliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action," with reliance requiring that the defendant's allegedly deceptive acts be disclosed to the investing public. *Stoneridge*, 128 S.Ct. at 769-70. *Stoneridge* involved a claim against two vendors who allegedly participated in creating "wash" transactions with a cable TV company knowing that those transactions would be used by the company to misstate its financials and thereby deceive investors. The Supreme Court affirmed the decision of the Eighth Circuit and held that the Section 10(b) claim against the two vendors failed "because it did not have the requisite proximate relation to the investors' harm." *Id.* at 769. The Supreme Court disallowed any presumption of reliance by investors on the alleged vendor actions which were not communicated to the public. Absent the investing public's knowledge, actual or presumed, of the deceptive acts during the relevant time period, there could be no adequate showing of reliance upon the deceptive acts, "except in an indirect chain that we find too remote for liability." *Id.* The Court stated that, were plaintiffs' concept of reliance to be adopted, Section 10(b) actions "would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule." *Id.* at 770.

In several recent (pre-*Stoneridge*) 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),

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[13] *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.

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 allegedly false financial 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 affirmed in *Central Bank*, and more recently by *Stoneridge*, that a secondary actor can be liable only if the plaintiff relies on the secondary actor's own misstatement or other deceptive conduct; and it does so by creating a fiction that the market will assume that misstatements or other deceptive conduct not attributed to an auditor are nevertheless made by that auditor simply by virtue of the public's alleged general 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. *Lernout & Hauspie*, 230 F. Supp. 2d 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. This aspect of the *Lernout* ruling is at odds with *Central Bank's* insistence on reliance and *Stoneridge's* clear mandate that "[r]eliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action." *Stoneridge*, 128 S.Ct. at 769.[14]

[14] In another decision, the *Lernout* court similarly displayed a broad conception of the reliance principle:

> 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.

In re Lernout & Hauspie Sec. Litig., 236 F. Supp. 2d 161, 174 (D. Mass. 2003). The *Lernout* 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, In contrast, the *Lernout* 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. 230 F. Supp. 2d 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 case law 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 have ignored *Central Bank* elsewhere in its decisions. Additionally, the court's reasoning is unsatisfactory, as independent auditors do not "prepare, draft, edit or provide numbers for the audit" nor, except in the most extraordinary of circumstances, can they be credibly alleged to have done anything more than opine regarding whether a company's financial statements are fairly presented. Moreover, if the auditors did prepare the financial statements or parts of them, they would not be deemed "independent," and, accordingly, they would have misrepresented their status as GAAS requires independence.

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 based on requisite

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even if a material misstatement by another person creates the nexus between the scheme and the securities market." *Id.* at 173.

reliance. 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.[15] Presumably, if anywhere, the answer lies in the widely recognized Andersen "white paper" on telecommunications industry accounting for capacity swaps and the like. The "white paper" put Andersen's brand on the accounting in a unique and relatively rare circumstance.

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). The recent *Stoneridge* decision and its affirmation of *Central Bank* and the reliance requirement should set the stage to reign in courts bent on expanding liability for auditors and other secondary actors, although the Supreme Court's passing reference in *Stoneridge* that conduct absent a misrepresentation may give rise to primary liability may serve to raise doubts about the boundaries of reliance and the requisite relationship to the investor's alleged harm. *See Stoneridge*, 128 S.Ct. at 769 ("If this conclusion were read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous. Conduct itself can be deceptive").

B. <u>Scheme Liability Under Rule 10b-5</u>

Another theory of liability as to secondary actors that plaintiffs' counsel have espoused is so-called "scheme liability" under subsections (a) and (c) of Rule 10b-5. While some practitioners hoped that the Supreme Court would validate or reject scheme liability in *Stoneridge,* it did not do so head-on. It did, however, determine that "what some courts call 'scheme liability'" on the basis of which plaintiffs sought to impose liability "even absent a public statement," did not give rise to the requisite reliance on defendants' allegedly deceptive conduct. *Stoneridge*, 128 S.Ct. at 770. In short, the Supreme Court in *Stoneridge* affirmed

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[15] 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."

Central Bank's adherence to the reliance requirement, while it arguably left the viability of some form of "scheme liability" based on deceptive conduct uncertain.

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* and more recently *Stoneridge* has clearly explained that the scope of Rule 10b-5 may not exceed that of Section 10(b). *Central Bank*, 511 U.S. at 173; *Stoneridge*, 128 S.Ct. at 768.

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.

Prior to the *Stoneridge* decision by the Supreme Court, three Circuit Courts had 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.)*, 482 F.3d 372 (5th Cir. 2007)).

In *In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006) (*affirmed by Stoneridge Inv. Partners LLC v. Scientific-Atlanta Inc.*, 128 S. Ct. 761 (2008)), two defendants, Scientific-Atlantic and Motorola had allegedly engaged in a scheme with Charter Communications to create a series of sham round-trip accounting transactions that allowed Charter Communications to overstate its revenue. Plaintiffs brought suit against Scientific-Atlantic and Motorola; the district court dismissed and the Eighth Circuit affirmed. In doing so, the Eighth Circuit applied Supreme Court precedent directly to the effect that (1) as per *Central Bank*, there can be no liability for aiding and abetting; (2) liability is limited to that set forth in Section 10(b) and Rule 10b-5 cannot provide for broader liability than Section

10(b); (3) pursuant to *Central Bank*, Section 10(b) only prohibits misstatements (or actionable omissions) and market manipulative devices or schemes; and (4) 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." Thus, *Charter Communications* basically concluded that "scheme liability" had no place in Section 10(b) jurisprudence.

In *Regents of the University of California et al. v. Credit Suisse First Boston (USA), Inc. et al (Enron Sec. Litig.)*, 482 F.3d 372 (5th Cir. 2007), the Fifth Circuit, while highlighting the reliance requirement in the context of that class certification decision, agreed with the Eighth Circuit's analysis and held there could be no scheme 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 those banks allegedly knew that the deals were 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.*

2. <u>Effect of *Stoneridge* on Scheme Liability</u>

Perhaps disappointingly, or perhaps in the vein of classic Supreme Court jurisprudence, the *Stoneridge* decision drew one clear line while leaving much else unaddressed. The Supreme Court in *Stoneridge* affirmed the Eighth Circuit's *Charter Communications* decision, but on different grounds. As noted above, while affirming that aiding and abetting liability has no place in private Section 10(b) jurisprudence, the critical element to the *Stoneridge* court was reliance. It held that there could be no liability for Charter Communications' vendors because the market did not know of their participation and could not have relied on it. The Eighth Circuit had followed what it deemed to be Supreme Court precedent to the effect that Section 10(b) only prohibits deceptive acts, defined as misstatements or omissions, and manipulative acts limited to market rigging, security wash sales and the like. The *Stoneridge* court disagreed with this analysis, ruling that

> The Court of Appeals concluded petitioner had not alleged that respondents engaged in a deceptive act within the reach of the § 10(b) private right of action, noting that only misstatements, omissions by one who has a duty to disclose, and manipulative trading practices (where "manipulative" is a term of

> art, see, *e.g. Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 , 476-77 (1977)), are deceptive within the meaning of the rule. If this conclusion were read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous. Conduct itself can be deceptive, as respondents concede. In this case, moreover, respondents' course of conduct included both oral and written statements, such as the backdated contracts agreed to by Charter and respondents.

Stoneridge, 128 S.Ct. at 769.

While the Supreme Court in *Stoneridge* was certainly principled in requiring reliance as an essential element of any Section 10(b) claim, it left unexplained its own prior precedent that limited the scope of Section 10(b) to misrepresentations, omissions and manipulative acts. *See 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."). *Stoneridge* noted that in the "typical" §10(b) private action, plaintiff must prove "a material misrepresentation or omission by the defendant." Yet, *Stoneridge* leaves unanswered (at least in part) the question of when a deceptive act as opposed to statement or omission, may qualify for primary liability under Section 10(b). It did, however, note that Section 10(b) provides that "the deceptive act must be 'in connection with the purchase or sale of any security,'" thereby providing "some insight into the deceptive acts that concerned the enacting Congress." 128 S.Ct. at 770.[16]

[16] *Stoneridge* seems to leave in place the specific meaning of "manipulative act" established by precedent. *Stoneridge* referenced the Eighth Circuit's understanding of "manipulative" from the *Santa Fe* line of cases to be a "term of art." *See Stoneridge*, 128 S.Ct. at 769 (citing *Santa Fe*). *See also Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977) ("Manipulation 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."); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) (Section 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.").

Certain district courts, however, including *Global Crossing*, 322 F. Supp. 2d at 336-37, have rejected what appears to be a settled definition of "manipulative." The *Global Crossing* court, for example, pointed 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.

3. Application of Scheme Liability as to Auditors (pre-*Stoneridge*)

Putting aside uncertainties regarding the scope or survival of scheme liability after *Stoneridge*, for purposes of this article it is useful to note that scheme liability has been used (pre-*Stoneridge*) most often against banks, venture capital funds and the like and has rarely been used, and even more rarely upheld, against auditors.[17] 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 *Global Crossing*, 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 case law 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 deceptive 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 by way of deceptive conduct.[18] 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

[17] For example, in *In re WorldCom, Inc. Sec. Litig.*, 2003 U.S. Dist LEXIS 10863, *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. In *In re Royal Dutch/Shell Transport Securities Litigation*, the court sidestepped plaintiffs' scheme liability allegations. 380 F.Supp.2d 509, 568 n.18 (D.N.J. 2005) ("Lead Plaintiff also claims that KPMG NV and PwC UK are liable under Rule 10b-5(a) and (c) for scheme liability, however, because the Court finds Plaintiff's allegations supporting its 10(b) claim to be sufficient, this Court will not analyze the claims under the theory of scheme liability.").

[18] 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. Perhaps the better approach would be to disallow the claim in such circumstances as nothing more than a "short cut" around *Central Bank. 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.").

> 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 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.*

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

Another issue of interest in current securities litigation involving auditors, particularly in cases with international components, is the propriety of bringing into lawsuits entities related to the auditor who 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 which have had no direct 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. As described below, plaintiffs have employed a variety of theories in this endeavor with varying degrees of success.

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.[19] Although Deloitte & Touche Italy and Grant Thornton Italy had undertaken to perform the audits of Parmalat's financial statements, plaintiff pled that the firms had served as the "agents" of Deloitte & Touche's and Grant Thornton's international umbrella organizations, Deloitte Touche Tohmatsu (DTT) and Grant Thornton International (GTI), respectively. In denying motions to dismiss brought by DTT and GTI, the court first explained 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 when the principal retains a degree of control over the

[19] 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.

agent. 375 F. Supp. 2d at 290.[20] Turning to the facts alleged, the *Parmalat* 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 &Touche Italy had sought direction and help from DTT in connection with the audits, "it could be inferred that DTT was in ultimate control of the audit." *Id.* at 294-95. Noting also that the logo of DTT appeared on the audit reports issued by Deloitte & Touche Italy, the court concluded that the agency-based claim against DTT was adequately pled. With respect to the Grant Thornton firms, the court ruled 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 pled. *Id.* at 300-01.

The plaintiffs in *Parmalat* went further and alleged that the US firms, Deloitte & Touche LLP (US) and Grant Thornton US, were liable for the acts of Deloitte & Touche Italy and Grant Thornton Italy, respectively, on a variety of agency theories. While the court rejected the attempt with respect to Deloitte & Touche US, it eventually allowed the claims with respect to Grant Thornton on a third amended complaint and in a separate but related common law malpractice and fraud action brought by Parmalat's bankruptcy trustee against its auditors (*In re Parmalat Sec. Litig., Bondi v. Grant Thornton Int'l et al.*, 421 F. Supp. 2d 703 (S.D.N.Y. 2006)). In the *Bondi* case, the court concluded that for pleading purposes, enough had been alleged to allow a case to proceed against Grant Thornton's US firm on the theory that Grant Thornton US controlled and dominated GTI, and that, because the court had already determined at the pleading stage that allegations that Grant Thornton Italy was the agent of GTI were sufficient, Grant Thornton Italy could be deemed the (sub-)agent of Grant Thornton US. The court found the following allegations adequate to make out the relationship (at the pleading stage): Grant Thornton US is the largest member firm of the international organization and through its size, personnel and enormous financial resources allegedly "dominates" GTI's Management Board, co-owns and regulates use of the worldwide rights to the Grant Thornton names, and controls whether proposed member firms will be admitted to the international organization, whether the GTI member firm agreement may be amended, whether the number of members on the GTI board will be changed, and whether GTI will be dissolved. 421 F. Supp. 2d at 719. The court reaffirmed the same conclusion on the pleadings in *In re Parmalat Securities Litigation*, 474 F. Supp. 2d 547, 552 (S.D.N.Y. 2007).

In contrast, in *Lernout & Hauspie*, the court rejected plaintiffs' attempts to impose single entity liability on KPMG's various world entities. In doing so, it noted that, although 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.

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[20] 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.

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). Plaintiffs did not allege that AWSC had actively participated in any way in the auditing or the alleged 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 when it conducted the WorldCom audits.

In yet another case, plaintiffs were unable to allege 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 person agreed to act on behalf of the other person and subject to its control. *Id*., 2006 WL 2331138, at *5-6.

2. <u>Use of Alter Ego Theory to Bring In Member Firms</u>

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 the Deloitte & Touche US firm and Grant Thornton US firm 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' alleged misdeeds. *Parmalat*, 375 F. Supp. 2d at 291; 296-97; 301-02. Plaintiffs alleged little more than that the Deloitte & Touche 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.

3. <u>Use of Control Person Liability to Bring in Member Firms</u>

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 for control person liability purposes under Section 20(a) that Deloitte & Touche US controlled the Deloitte international organization, DTT. *Parmalat*, 375 F. Supp. 2d at 311. By this theory then, Deloitte & Touche US could be held responsible not only for DTT's liability, but also for that of DTT's "agent," Deloitte & Touche Italy. In a subsequent opinion, after having determined that enough had been alleged to find that Grant Thornton US exercised enough control over the international Grant Thornton organization for agency liability to arise, the court also found enough had been pled to allow a claim to proceed against Grant Thornton US under Section 20(a). *In re Parmalat Securities Litigation*, 474 F. Supp. 2d 547, 554 (S.D.N.Y. 2007).

In *Schnall v. Annuity and Life RE (Holdings), Ltd.*, 2006 WL 2331138 (D. Conn. Aug. 10, 2006), the court reached a contrary result on the facts presented 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 would have to allege, but did not, 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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