

THE REVIEW OF SECURITIES & COMMODITIES REGULATION

AN ANALYSIS OF CURRENT LAWS AND REGULATIONS
AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 50 No. 1 January 11, 2017

2017 Begins Our 50th Year of Publication!
Thanks to all who have contributed.

RECENT TRENDS IN SEC ENFORCEMENT ACTIONS AGAINST AUDITORS

Based on a statistical review, the authors find that the Commission has shown no signs of slowing down the increased pace and volume of enforcement actions against auditors in the first three quarters of 2016. The authors report the numbers and then discuss the types of cases the SEC has most often pursued, its policy on admissions of wrongdoing, and the suspension or bar of auditors found guilty of violations.

By Lisa C. Wood and Matthew Miller *

After joining the SEC in 2013, Chair Mary Jo White announced that the SEC would refocus its attention on financial disclosure in general, and auditors in particular, because they “serve as critical gatekeepers — experts charged with making sure that the processes that companies use to prepare and report financial information are ones that are built on strength and integrity.”¹ The SEC thereafter launched “Operation Broken Gate,” an initiative aimed “to identify auditors

who neglect their duties and the required auditing standards.”² Considered together with the Financial Reporting and Audit (“Fraud”) Task Force, also launched in 2013, Operation Broken Gate promised an increase in Enforcement Division matters directed at financial statement auditors.

The SEC’s recent renewed focus on financial reporting and alleged audit failures has borne significant enforcement fruit according to Andrew Ceresney, Director of the Division of Enforcement. Since

¹ Chair Mary Jo White, Remarks at the Securities Enforcement Forum (Oct. 9, 2013), available at <https://www.sec.gov/News/Speech/Detail/Speech/1370539872100>.

² *Id.*

* LISA C. WOOD is a partner at Foley Hoag, where she chairs the Litigation Department and handles complex business litigation and enforcement matters involving accountants’ liability, securities, and antitrust issues. MATTHEW MILLER is a partner at Foley Hoag, where he chairs the firm’s e-Discovery Committee and handles matters involving accountants’ liability, securities litigation and investigations, and commercial litigation. Both are members of Foley Hoag’s auditor defense practice, and routinely represent all of the Big 4 and other national firms in SEC enforcement and private litigation matters. Their e-mail addresses are lwood@foleyhoag.com and mmiller@foleyhoag.com.

INSIDE THIS ISSUE

- THE IMPACT OF OMNICARE ON AUDITOR LIABILITY UNDER THE FEDERAL SECURITIES LAWS, Page 9

launching Operation Broken Gate and the Fraud Task Force, the SEC has more than doubled the number of enforcement actions filed annually in the issuer reporting and disclosure area, which includes auditors, from 53 in fiscal 2013 to 114 in fiscal 2015.³ In the same timeframe, according to Director Ceresney, the SEC has also doubled the number of Rule 102(e) proceedings filed against accountants, from 37 in fiscal 2013 to 76 in fiscal 2015.⁴

Has the SEC kept up this focus on what it sees as financial reporting audit failures in 2016? “Yes,” says Director Ceresney. In September 2016, he noted that “[g]iven the importance of financial reporting and auditing to the integrity of our markets and the protection of investors, and the SEC’s unique ability to do such complex cases, failures in that sphere must always be a high priority for the Division.”⁵ Speaking to the American Law Institute 2016 Conference on Accountants’ Liability, Director Ceresney noted the SEC has focused on bringing enforcement, making the following allegations against auditors: (1) auditors lack the requisite capacity or competence to handle a matter; (2) auditors unduly rely on management representations or fail to properly test management estimates; (3) auditors conduct “essentially” no audit at all; (4) auditors fail to sufficiently document the audit; and (5) auditors have violated the independence rule. In addition, Director Ceresney noted that in 2015 the SEC charged audit firms, in addition to individual auditors, in non-independence cases for the first time since 2009.

The SEC has therefore certainly focused much attention on enforcement actions against auditors in their recent speeches and publications. But do the SEC’s most recent enforcement efforts match the rhetoric? To find out, we examined all Accounting and Auditing Enforcement Releases (“AAER”) concerning enforcement actions against auditors and audit firms instituted from January 1, 2016 through September 30, 2016.⁶ Our goal was to gauge the level of recent SEC enforcement activity against auditors, and also to understand the substantive areas that have recently received the most attention by the Enforcement Division. This article shares what we have learned from an in-depth examination of enforcement actions filed against auditors during the first three quarters of 2016, including whether the SEC is on pace with its recent past efforts in addressing purported audit failures, what types of cases the SEC has most often pursued, and whether the SEC has pursued enforcement actions against firms directly. We also briefly examine the Commission’s significant decision in the *Aesoph* case, which could not only influence how Enforcement Division staff devise penalty schemes in the future, but could also have a chilling effect on the potential for meaningful federal judicial review of Commission decisions.

A Look at the Numbers

The SEC has shown no signs of slowing down the increased pace and volume of enforcement actions against auditors in the first three quarters of 2016. Based on AAERs concerning enforcement actions filed in 2016 through September 30, the SEC instituted 37 enforcement actions against outside accountants, up slightly from the 35 actions against outside accountants brought by the SEC through the same period in 2015. Ten, or 27%, of these 2016 enforcement actions named accounting firms as defendants, roughly on par with the 29% of enforcement actions naming firms through Q3 2015.

³ Director Andrew Ceresney, Remarks at the American Law Institute Conference on Accountants’ Liability 2016 (*available at* <https://www.sec.gov/news/speech/ceresney-enforcement-focus-on-auditors-and-auditing.html>).

⁴ *Id.* SEC Rule 102(e) authorizes the SEC to deny persons the privilege of appearing or practicing before the Commission if they are found to have engaged in “improper professional conduct” as defined in the rule.

⁵ Director Andrew Ceresney, The SEC Enforcement Division’s Focus on Auditors and Auditing, Sept. 22, 2016, *available at* <https://www.sec.gov/news/speech/ceresney-enforcement-focus-on-auditors-and-auditing.html>.

⁶ AAERs concern “financial reporting related enforcement actions concerning civil lawsuits brought by the Commission in federal court, and notices and orders concerning the institution and/or settlement of administrative proceedings.” <https://www.sec.gov/divisions/enforce/friactions.shtml>.

Naming the Firm

What do these 10 enforcement matters tell us about the SEC's decision to charge firms in general? For the most part, the SEC's decisions in these cases appear to be consistent with guidelines announced by Enforcement Division staff in 2006, setting forth the factors that staff would consider in determining whether to impose penalties on corporate entities as distinct from individual actors.⁷ While the 2006 guidelines were explicitly directed at corporate issuers, several of the factors outlined by the SEC could also be applicable in the auditor context. For instance, the SEC has stated that in deciding whether to pursue enforcement against entities, it will consider (1) whether there is a need to deter the particular type of offense; (2) the extent of the injury to innocent parties; (3) whether complicity in the violation is widespread throughout the corporation; (4) the level of intent on the part of the perpetrators; and (5) the degree of difficulty in detecting the particular type of offense, among other factors. Most prominent among cases where the SEC charges firms are those involving alleged violations of the auditor independence rule, and allegations of widespread or particularly egregious violations of professional standards.

Auditor Independence: The two most recent matters the SEC has brought against an accounting firm — in both cases, Ernst & Young — involved alleged violations of the auditor independence rule.⁸ Given the importance of auditor independence to the SEC, the SEC likely views all of the above factors as potentially in play when it believes an auditor's independence from the audit client is lacking. Generally accepted auditing standards (GAAS) require auditors to be independent from their audit clients in both fact and appearance.⁹ Rule 2-01(b) of Regulation S-X provides the general independence rule that an auditor will not be deemed independent “if the accountant is not, or a reasonable

investor . . . would conclude that the accountant is not, capable of exercising objective and impartial judgment.” Rule 2-01(c) provides a non-exhaustive list of relationships between an auditor and client that would violate the general independence principle, including financial, business, and employment relationships.

Neither of the two recent independence cases in which the SEC charged the audit firm involved relationships that are explicitly prohibited by Rule 2-01(c). In one case, the lead audit partner developed a close friendship with the audit client chief financial officer. In the other, the audit engagement partner engaged in a romantic relationship with the chief accounting officer of the audit client. Close personal relationships between auditor and client are not explicitly prohibited by Rule 2-01(c). The SEC nevertheless contended that the firm and its personnel violated the general independence rule, not because each auditor *in fact* lacked independence, but because a “reasonable investor with knowledge of all [the] relevant facts and circumstances [of the relationship in each case] would conclude that [each audit partner] was not capable of exercising objective and impartial judgment with respect to the audits of the Issuer.”

While the SEC did not explicate its rationale for charging the firm in these two recent independence cases, in its press release announcing the actions, the SEC noted that the firm's procedures to assess independence “did not specifically inquire about non-familial close personal relationships that could impair the firm's independence.”¹⁰ Thus, notwithstanding that these were, as the SEC acknowledged, “the first SEC enforcement actions for auditor independence failures due to close personal relationships between auditors and client personnel,” the Division appeared to deem it appropriate to charge the firm to address what it saw as a systemic issue, and perhaps to encourage other audit firms to adopt changes to their procedures as well. In any event, the SEC has made clear its desire to deter violations of the independence rule, noting that “circumstances that raise questions about an accountant's independence always merit heightened scrutiny.”¹¹ The SEC has continued to apply this “heightened scrutiny” in 2016, bringing a number of

⁷ <https://www.sec.gov/news/press/2006-4.htm>.

⁸ *In the Matter of Ernst & Young LLP et al.*, AAER Rel. No. 3802 (Sept. 19, 2016); *In the Matter of Ernst & Young LLP et al.*, AAER Rel. No. 3803 (Sept. 19, 2016).

⁹ PCAOB Rule 3520; PCAOB Auditing Standards, Independence, AU § 220.03 (“Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To *be* independent, the auditor must be intellectually honest; to *be recognized* as independent, and he must be free from any obligation to or interest in the client, its management, or its owners.”).

¹⁰ Press Release, U.S. Secs. & Exch. Comm'n, *Ernst & Young, Former Partners Charged With Violating Auditor Independence Rules* (Sept. 19, 2016), available at <https://www.sec.gov/news/pressrelease/2016-187.html>.

¹¹ Amendment to Rule 102(e), Commission's Rules of Practice, Rel. No. 7593 (Oct. 19, 1998).

additional enforcement matters alleging a failure to satisfy the auditor independence rule.¹²

Alleged Egregious, Widespread, and Obvious Errors: In other cases where the SEC has pursued enforcement actions against accounting firms, the SEC emphasized its allegations that the violations of professional standards were widespread, egregious, and indicated a high degree of intent on the part of individual actors involved.

For example, the SEC alleged that accounting firm EFP Rotenberg willfully violated Section 10A of the Securities Exchange Act in failing to conduct an audit that included procedures designed to provide reasonable assurance of detecting illegal acts.¹³ During its audit of ContinuityX, a commission-based sales agent selling internet services provided by internet providers (ISPs), EFP Rotenberg became aware that ContinuityX paid kickbacks to customers to sign up for the ISPs' services that the customers neither intended to pay for or use. The SEC alleged that as a result of these customer agreements, over 99.8% of the revenue reported by ContinuityX in its financial statements was revenue it had not earned. The kickback agreements also conflicted with a number of management's representations concerning chargebacks and revenue recognition, but EFP Rotenberg failed to investigate these conflicts. Likely also relevant to the SEC's enforcement decision, the firm and audit partner involved had been censured and suspended only two years prior in another enforcement action arising from an audit of a different client. EFP Rotenberg entered into a settlement agreement with the SEC where the firm did

not admit to any wrongdoing, and agreed to pay a civil monetary penalty of \$100,000 and engage in a number of remedial efforts. The audit partner was permanently barred from appearing before the SEC as an accountant and assessed a \$25,000 penalty.

In another enforcement action brought against an accounting firm, the SEC alleged that Frazer Frost, a California-based firm, was told by the audit client CEO that the value of a recent acquisition was materially misstated in the client's Form 10-Qs for the first and second quarter of 2010.¹⁴ The audit firm, however, allegedly failed to communicate these inaccuracies to the company's management or audit committee. And the client's third quarter Form 10-Q was filed containing the same known material misstatements. In addition, during the 2011 audit of the same client, the firm included in its audit plan testing of value-added-tax (VAT) payments made by the audit client's subsidiaries, but allegedly failed to conduct the testing. The client's subsequent auditors later discovered that while the financial statements reflected a \$1.7 million VAT payment by a subsidiary, in reality the subsidiary had paid only \$44,000 in VAT. In a settlement agreement with the SEC, the firm admitted no wrongdoing but was barred from appearing before the SEC with a right to request reinstatement in five years.

As a likely example of naming an accounting firm as a respondent to address widespread failures, the SEC alleged that Michigan firm Silberstein Ungar PLLC performed deficient audits across separate engagements for nine different issuer clients.¹⁵ The audit deficiencies alleged by the SEC, each ranging across a number of engagements for different clients, included a failure to (1) obtain sufficient appropriate audit evidence; (2) evaluate management's accounting estimates; (3) document procedures performed regarding adequacy of disclosure in the financial statements; (4) obtain appropriate engagement quality reviews; and (5) evaluate journal entries for possible misstatement due to fraud.

"Red Flags" and Management Representations

Apart from a continued focus on auditor independence, cases brought in the first three quarters of 2016 reveal that, consistent with Director Ceresney's prior statements, the SEC continues to focus on

¹² The SEC also alleged accounting firms violated the independence rule in three additional enforcement actions filed through the end of Q3 2016. See *In the Matter of D'Arelli Pruzansky, P.A. et al.*, AAER Rel. No. 3809 (Sept. 30, 2016) (two senior audit partners failed to comply with audit partner rotation requirements across separate engagements for five different clients); *In the Matter of David S. Hall, P.C. et al.*, AAER Rel. No. 3771 (Apr. 26, 2016) (violation of audit partner rotation requirement; self-dealing); *In the Matter of Elliot R. Berman, CPA et al.*, AAER Rel. No. 3760 (Mar. 25, 2016) (indemnification provision in engagement letter violated independence rule; the SEC's Office of the Chief Accountant has taken the position that "including in engagement letters a clause that a registrant would release, indemnify, or hold harmless from any liability and costs resulting from knowing misrepresentations by management would ... impair the firm's independence." Berman had this type of provision in his audit engagement agreement with the audit client.).

¹³ *In the Matter of EFP Rotenberg, LLP et al.*, AAER Rel. No. 3790 (July 22, 2016).

¹⁴ *In the Matter of Frazer Frost, LLP et al.*, AAER Rel. No. 3781 (June 7, 2016).

¹⁵ *In the Matter of Silberstein Ungar PLLC et al.*, AAER Rel. No. 3777 (June 6, 2016).

allegations that auditors improperly relied on management representations despite the presence of supposed “red flags.” In addition to the *EFP Rotenberg* and *Frazer Frost* cases discussed above, which also involved alleged misplaced reliance on management representations, the cases below are illustrative:

- *In the Matter of Bioelectronics Corp et al.*: issuer falsely recognized 47% of its revenue from two transactions entered into near the end of the financial period where no delivery date for the product had been set; audit partner failed to obtain sufficient evidence of a fixed delivery schedule, relying instead on management’s representation that a delivery date had been finalized.¹⁶
- *In the Matter of Robert D. Hesselgesser, CPA*: Audit client Ener1 held an equity investment in and made loans to a related party named Think. The audit partner became aware of facts suggesting that Ener1’s Think-related assets were impaired, including that Think ceased to pay its bills, and that Think continued to require funding and loans from Ener1 to operate. The SEC alleged that in accepting management’s conclusion that Ener1’s Think-related assets were not impaired, the audit partner relied solely on management’s representations and did not request sufficient corroborating evidence, including documents reflecting Think’s financing efforts, Think Board minutes, or the identity of other Think investors.¹⁷
- *In the Matter of Eliot R. Berman, CPA*: The SEC alleged that the auditor improperly relied on CFO’s statements that sales incentives were appropriately accounted for in the audit client’s financial statements, notwithstanding that the auditor had identified revenue recognition as a significant fraud risk area in the audit, and concluded that the CFO lacked the requisite technical accounting expertise necessary to support SEC financial reporting.

The SEC’s focus on improper reliance on management representations has continued in the fourth quarter of 2016. In an AAER announcing a settlement agreement requiring a “Big 4” firm to pay \$9 million in disgorgement and \$1 million in penalties, the SEC alleged that the auditors were aware of post-closing adjustments the audit client made to artificially lower its year-end provision for income taxes, but relied on

management’s unsubstantiated explanations instead of performing required audit procedures.¹⁸

Admission of Wrongdoing

In June 2013, SEC Chair White announced a change in the SEC’s longstanding policy of settling virtually all of its cases on a no-admit-no-deny basis. Chair White noted that in most cases that policy “makes very good sense,” but “there are some cases where monetary penalties and compliance enhancements are not enough. An added measure of public accountability is necessary, and in those cases we should demand it.”¹⁹ Pursuant to its revised policy, the SEC would require admissions of wrongdoing in settlements resolving cases where (1) a large number of investors have been harmed or the conduct was otherwise egregious; (2) the conduct posed a significant risk to the market or investors; (3) admissions would aid investors deciding whether to deal with a particular party in the future; and (4) reciting unambiguous facts would send an important message to the market about a particular case.

In last quarter of 2015, the SEC required two national accounting firms to admit wrongdoing in settlements for the first time since the 2013 policy change.²⁰ Naturally, auditors may wonder whether a trend requiring admissions in settlement agreements involving auditors has blossomed through 2016. While the SEC has not forced any auditors to admit wrongdoing in settlement agreements filed in 2016, it has forced admissions of wrongdoing in other 2016 enforcement matters. It remains to be seen whether the SEC will use this tool in its enforcement arsenal against the accounting profession with any increasing regularity in the future.

Suspension vs. Bar

A fairly extraordinary 2016 decision by the full Commission on appeal from an Administrative Law Judge (ALJ) decision may dictate whether, in future cases, Enforcement Division staff will pursue suspension or permanent bars when asking that auditors be precluded from practicing before the Commission due to

¹⁶ AAER Rel. No. 3740 (Feb. 5, 2016).

¹⁷ AAER Rel. No. 3767 (Apr. 19, 2016).

¹⁸ *In the Matter of Ernst & Young, LLP et al.*, AAER Rel. No. 3814 (October 18, 2016).

¹⁹ Chair Mary Jo White, *Deploying the Full Enforcement Arsenal*, Sept. 26, 2013 <https://www.sec.gov/News/Speech/Detail/Speech/1370539841202>.

²⁰ *In the Matter of BDO USA, LLP*, AAER Rel. No. 3692 (Sept. 9, 2015); *In the Matter of Grant Thornton, LLP*, AAER Rel. No. 3718 (Dec. 2, 2015).

their alleged violations.²¹ The difference between suspensions and bars is significant. Barred respondents may be permanently precluded from practicing before the Commission or the SEC may allow the respondent to request reinstatement after a certain period of time. The reinstatement process can take years to reach a decision and reinstatement is by no means assured. In contrast, respondents that are suspended may automatically resume their practice before the Commission once their period of suspension runs, without seeking the approval of the Commission.

The two auditor respondents in the *Aesoph* case appealed an ALJ decision ordering their temporary suspension — the audit partner for one year, the audit manager for six months — for violating PCAOB auditing standards. The Division cross-appealed, contending that the audit partner should have received longer suspensions. Importantly, the Division did not ask the Commission to impose a *bar* on either Respondent. Rather, the Division merely asked the Commission to extend the suspensions that the ALJ imposed. Nevertheless, the Commission *sua sponte* imposed permanent bars with a right to request reinstatement after three years and two years on the partner and manager, respectively. In support of its decision, the Commission relied on its purported past practice of imposing “a suspension for up to 12 months or a bar with the right to apply for reinstatement after a period of years.”²² The Commission has thus signaled to the Division that going forward, where respondents are to be denied the privilege of appearing before the Commission for a period longer than one year, the sanction should be in the form of a permanent bar with a right to request reinstatement at a given time, not a temporary suspension.²³

²¹ *In the Matter of Joseph J. Aesoph, CPA et al.*, Exchange Act Rel. No. 78490 (Aug. 5, 2016).

²² *Id.* at 23 n. 84. Commissioner Piowar dissented from the Commission’s decision to bar the Respondents from practicing before the commission, noting that “[b]y imposing a permanent bar with the right to apply for reinstatement after three years and two years, the majority of the Commission has imposed a punitive sanction that goes far beyond what the Division requested.”

²³ We note that when an accountant is suspended or barred from appearing before the SEC, she cannot serve as the auditor for a public company, and in fact cannot be involved in the preparation of any SEC filings. See SEC Rule 102(f) (defining “practice before the Commission” to include the “preparation of any statement, opinion, or other paper by any attorney, accountant, engineer, or other professional or expert, filed with

In addition, the *Aesoph* decision may also have the effect of discouraging federal judicial review of SEC administrative proceedings at a time when the Enforcement Division is increasingly choosing to bring enforcement matters before ALJs rather than federal district courts. As a result of *Aesoph*, respondents will likely be more wary of appealing ALJ decisions to the Commission, knowing that the Commission could not only increase the penalties levied by the ALJ, but could also go beyond even what the Enforcement Division staff requests. But respondents must first appeal an ALJ decision to the Commission prior to obtaining federal court review.²⁴ Thus *Aesoph* may have the effect, intended or not, of dissuading respondents from seeking federal court review of SEC decisions because respondents will avoid the risk of first appealing to the Commission and having the Commission increase penalties on its own volition. This prospect of limited judicial review is even more troubling when considering that several circuits have recently held that even constitutional challenges to the SEC’s administrative process must first be presented to an ALJ and reviewed by the Commission before receiving federal judicial review.²⁵ Ironically, the SEC has prevailed in those circuit cases in part by arguing that respondents should be required to first exhaust their administrative remedies because the SEC administrative process provides an opportunity for “meaningful judicial review” of the Commission’s final decision.²⁶

footnote continued from previous column...

the Commission in any registration statement, notification, application, report, or other document with the consent of such attorney, accountant, engineer, or other professional or expert.”); *In re Robert W. Armstrong*, Exchange Act Release No. 51920, at 21 (Jun. 24, 2005) (Commission holding that “practicing before the Commission includes computing the figures and supplying the data incorporated into Commission filings, and consenting to their incorporation.”).

²⁴ 15 U.S.C. § 80b-13 (“Any person or party aggrieved by an order issued by the Commission under this title may obtain a review of such order in the circuit court of appeals of the United States within any circuit, wherein such person resides or has his principal office or place of business ...”).

²⁵ *Hill v. SEC*, 825 F.3d 1236 (11th Cir. 2016); *Tilton v. SEC*, 824 F.3d 276 (2d Cir. 2016); *Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015); *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015), *cert. denied*, 136 S. Ct. 1500 (2016).

²⁶ See, e.g., *Jarkesy*, 803 F.3d at 27 (respondent had opportunity for meaningful judicial review of his Article II challenge because his “rights can be vindicated by a reversal of the

Any development that further insulates the SEC administrative proceedings from judicial review is alarming. This is because the SEC has increasingly relied on administrative proceedings instead of district courts when bringing enforcement matters since the passage of Dodd-Frank, which expanded the SEC's authority to impose penalties in the administrative arena.²⁷ Indeed, all of the enforcement matters brought by the SEC against auditors in the first three quarters of 2016 were pursued administratively.

A Final Note on Arthur Young

These trends from the SEC — targeting auditors in enforcement matters, coupled with a growing penchant for its administrative courts at a time where those administrative decisions are increasingly insulated from judicial review — compel a response to one recent remark by Director of Enforcement, Andrew Ceresney. Speaking at the American Law Institute Conference on Accountants' Liability, Director Ceresney prefaced his remarks by harking back to the Supreme Court's statement in its *Arthur Young* case, where the Court refused to adopt an accountant-client privilege that an auditor serves as a "public watchdog" and owes "complete fidelity to the public trust."²⁸ The Director's reliance on *Arthur Young* of course ignores the intervening *three decades* of decisions in which courts have adopted a more nuanced and accurate view of an independent auditor's role, starting with the California Supreme Court's recognition in *Bily* that,

[a]n auditor is a watchdog, not a bloodhound. As a matter of commercial reality, audits are performed in a client-controlled environment.

The client typically prepares its own financial statements; it has direct control over and assumes primary responsibility for their contents.²⁹

With a more enlightened understanding of the auditor's role, courts have steadfastly rejected litigants' attempts to unjustly hold auditors accountable in private litigation brought under the federal securities laws or common law. Courts now uniformly recognize that a failure to identify problems with the client's internal controls or accounting practices, or the inability to detect another's fraud, does not render the auditor liable under the securities laws.³⁰ While enforcement efforts targeted at serious violations of professional standards will serve the best interest of investors, the markets and auditors, the SEC should not attempt to turn back the clock to obscure the true roles of auditors to gain an unfair advantage over the auditing industry.

CONCLUSION

In 2016, the SEC has kept up its recently increased pace of enforcement matters against auditors, focusing on independence issues and undue reliance on management representations. The SEC has also been willing in recent times to charge firms, in addition to the individuals engaging in securities violations, to address what it believes are systemic issues, not just within the firms involved in the particular matter, but also across the industry. Given the SEC's long-stated focus of making "failures by gatekeepers" a "high priority," coupled with the agency's renewed focus on policing financial disclosure issues, it is safe to assume these recent trends will not abate in the near future. ■

footnote continued from previous page...

Commission's final order if the court of appeals grants his petition for review").

²⁷ Director Andrew Ceresney, *Remarks to the ABA Business Law Section Fall Meeting* (Nov. 21, 2014) ("[W]hat we are doing now is simply making use of the administrative forum in cases where we previously could only obtain penalties in district court.").

²⁸ *Supra*, n. 3 (citing *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984)).

²⁹ *Bily v. Arthur Young & Co.*, 834 P.2d 745, 762 (Cal. 1992). See also *United States v. Deloitte LLP*, 610 F.3d 129, 142-43 (D.C. Cir. 2010) (refusing to find waiver of work product by virtue of disclosure to auditor based on auditor's "public watchdog" role, noting "[a]n independent auditor can fulfill its duties and render an opinion concerning a company's public financial statements without revealing every piece of information it reviews during the audit process. In short, [an] independent auditor[']s obligations do not make it a conduit to [the audit client's] adversaries.").

³⁰ See, e.g., *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000).

THE IMPACT OF OMNICARE ON AUDITOR LIABILITY UNDER THE FEDERAL SECURITIES LAWS

The Supreme Court's Omnicare decision, holding that statements of opinion are actionable under Section 11 of the Securities Act of 1933 only in limited circumstances has important implications for auditors' liability for their audit opinions. The author discusses the case and reviews subsequent lower court decisions extending Omnicare to Section 10(b) and Section 18 of the Exchange Act.

By Sarah L. Cave *

As lower courts apply the Supreme Court's holding in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*,¹ the developing jurisprudence confirms that the decision has profound implications for cases against auditors and that its reasoning applies not only to claims under Section 11 of the Securities Act of 1933,² as in *Omnicare* itself, but also to claims against auditors under Section 10(b) and Section 18 of the Securities and Exchange Act of 1934.³

In *Omnicare*, the Supreme Court addressed strict liability under Section 11 for misrepresentations or material omissions in registration statements, ruling that statements of opinion are actionable only in three limited circumstances: (1) the speaker subjectively believes the opinion to be untrue, (2) the opinion statement contains embedded statements of fact that are misleading, or (3) the opinion "omits material facts about the issuer's inquiry into or knowledge" about the statement, and those facts "conflict with what a reasonable investor would take from the statement itself."⁴ On the other hand, a genuinely held opinion, regardless of whether it is proven wrong, cannot be a misstatement giving rise to Section 11 liability.⁵

Although *Omnicare* did not directly address claims against auditors, the profession immediately began to

consider how the decision would apply to the "opinions" auditors provide regarding financial statements they have audited.

The Extension of Omnicare

While *Omnicare* explicitly concerned only Section 11 liability, the Section 11 language at issue — that a party is liable for "an untrue statement of material fact or omitted to state a material fact . . . necessary to make the statements therein not misleading" — is either identical or closely analogous to language in other federal securities laws, including Sections 10(b) and 18, statutes whose scopes are broader than Section 11, which is focused on registration statements. Perhaps unsurprisingly, then, district courts across the country began expanding — occasionally even without explicit analysis — *Omnicare*'s reach to these other, similarly phrased federal securities laws.⁶

Even decisions that declined to find *Omnicare* controlling in cases involving statutes other than

¹135 S. Ct. 1318 (2015).

²15 U.S.C. § 77.

³15 U.S.C. §§ 78a, 78r.

⁴ *Omnicare*, 135 S. Ct. at 1325-27, 1329.

⁵*Id.* at 1327.

⁶*See, e.g., In re Amarin Corp. PLC*, No. 13-cv-06663, 2015 WL 3954190, at *7 n. 14 (D.N.J. June 29, 2015) (assuming that *Omnicare*'s opinion statement analysis applied to the Section 10(b) claims at issue); *Corban v. Sarepta Therapeutics, Inc.*, No. 14-CV-10201-IT, 2015 WL 1505693, at *11 (D. Mass. Mar. 31, 2015) (applying *Omnicare* analysis to Section 10(b) claims); *In re Genworth Fin. Inc. Sec. Litig.*, 103 F. Supp. 3d 759, 766 (E.D. Va. 2015) ("*Omnicare*'s holding is applicable and relevant to the instant case as the standard defined in Section 11 of the Securities Act is nearly identical to the [Section 10(b)] standard at issue here.").

* SARAH L. CAVE is a partner at Hughes Hubbard & Reed LLP. Her e-mail address is sarah.cave@hugheshubbard.com. The author wishes to thank for their assistance in preparing this article Carl Mills, an associate at Hughes Hubbard, and Jesse Jensen and Karen Goldberg, former associates at the firm.

Section 11 nonetheless applied its reasoning and analysis.⁷

The Tenth Circuit was the first circuit court to expand the application of *Omnicare* to Section 10(b) claims. In *Nakkhumpun v. Taylor*, the plaintiffs challenged a statement made by the company’s president during a conference call to discuss quarterly financial results in which he said that the company was in a “far better financial situation” than the year prior.⁸ The Tenth Circuit confirmed that *Omnicare* applied to plaintiffs’ Section 10(b) claim and ruled that the facts allegedly known by the defendants — that the company was in poor financial health when the statement was made — were insufficient to “cast doubt on the sincerity or reasonableness of [the company president’s] statement of his opinion.”⁹

In its first opinion applying *Omnicare*, the Second Circuit also expressly affirmed the application of *Omnicare* to Section 10(b) claims. In *Tongue v. Sanofi*, the plaintiffs, holders of certain contingent value rights (“CVR”), asserted Section 10(b) claims against a pharmaceutical company, its predecessor, and three executives after the FDA did not approve the defendants’ drug (Lemtrada) before the date entitling the CVR holders to cash payouts.¹⁰ Examining the allegedly misleading opinions that the defendants made in the offering materials, the court applied *Omnicare* and emphasized the “need to examine the context” of the allegedly misleading opinion, including the sophistication of the plaintiffs. After rejecting the plaintiffs’ suggestion that *Omnicare* required the defendants to disclose FDA feedback arguably undermining the defendants’ optimistic projections, the

court held instead that *Omnicare* did not require that all information conflicting with an opinion be disclosed, even if investors might have acted differently had they known that information and affirmed dismissal of the complaint.

Application of Omnicare to Auditors

As *Omnicare*’s reach has expanded beyond Section 11, auditors have sought, with mixed success, to apply the limits imposed by *Omnicare* on liability for audit opinions. One of the first examples is *In re Velti PLC Securities Litigation*, in which a district court for the Northern District of California dismissed a Section 10(b) claim concerning allegations that auditor Baker Tilly’s opinions were false and omitted information about Velti’s difficulty in collecting certain receivables.¹¹ The court noted that “several courts to consider such statements [of opinion] under Section 10(b) since *Omnicare* have applied the *Omnicare* analysis,” and held that the pleading was insufficient as a matter of law because it failed to allege either that the auditor did not believe the bad debt reserves were inaccurate or that the auditor omitted specific facts that rendered the audit opinions misleading. The plaintiffs appealed the decision, but the parties reached a settlement in April 2016.

In two summary orders, the Second Circuit applied *Omnicare* in dismissing claims against auditors. First, in *Special Situations Fund III QP, L.P. v. Deloitte Touche Tohmatsu CPA, Ltd.*, the court applied *Omnicare* in upholding dismissal of a Section 18 claim against ChinaCast’s auditor, Deloitte’s Hong Kong member firm.¹² Plaintiffs were investors in ChinaCast, whose executives had perpetrated a years-long fraud. Plaintiffs alleged that Deloitte Hong Kong committed securities fraud when it issued “clean” audit opinions despite purportedly being aware of certain “red flags.” In affirming dismissal, the Second Circuit found that plaintiffs failed to allege that the auditor’s opinions constituted false or misleading statements, such as by alleging that the auditor did not honestly hold its opinions or that the auditor omitted material facts on which the opinions were based, allegations that were necessary in light of *Omnicare*.¹³

⁷ *In re Merck & Co., Inc. Sec., Derivative & ERISA Litig.*, No. 05-cv-01151, 2015 WL 2250472, at *11 n. 7 (D.N.J. May 13, 2015) (noting that while “*Omnicare*, actually, is not directly applicable” to Section 10(b) claims, “*Omnicare*’s analysis of its discussion of misleading opinions is . . . instructive on the viability of [those] claims as to the opinion-based” statements); *Firefighters Pension & Relief Fund of the City of New Orleans v. Bulmahn*, No. 13-3935, 2015 WL 7454598, at *25-26 (E.D. La. Nov. 23, 2015) (stating that “[i]t is not clear . . . that the Supreme Court’s analysis in *Omnicare* extends to securities fraud claims under Section 10(b) of the Securities Act of 1934” but “[i]n the case of non-forward-looking opinion statements, the Court will use *Omnicare* as guidance”).

⁸ 782 F.3d 1142 (10th Cir.), cert. dismissed, 136 S. Ct. 499 (2015).

⁹ *Id.* at 1159-60.

¹⁰ 816 F.3d 199 (2d Cir. 2016).

¹¹ 13-CV-03889-WHO, 2015 WL 5736589, at *35 (N.D. Cal. Oct. 1, 2015).

¹² No. 15-1813, 645 F. App’x 72, 2016 WL 1392280 (2d Cir. Apr. 8, 2016), cert denied 137 S. Ct. 186 (2016).

¹³ *Id.* at *3.

The Second Circuit again applied *Omnicare* in its summary order in *Querub v. Moore Stephens Hong Kong*, affirming summary judgment for auditor Moore Stephens Hong Kong.¹⁴ The plaintiff investors had alleged that the auditor overlooked a fraud committed by a Puda Coal executive. The Second Circuit ruled that, although the auditor had issued unqualified opinions on financial statements that failed to note the sale of the Chinese company's sole assets, the investors did not present sufficient evidence for their Section 11 claim because they failed to show that Moore Stephens either did not believe its opinions or that its audit reports omitted material facts about the basis of its opinions.¹⁵

Other courts have sustained claims against auditors in the face of *Omnicare* challenges. In *In re Lehman Brothers Securities & ERISA Litigation*, the court denied Ernst & Young's motion for summary judgment on a claim concerning its audits of the defunct investment bank Lehman Brothers.¹⁶ The court found that plaintiffs presented evidence sufficient to raise a genuine issue of material fact as to six "red flags" which, when taken as a whole, "could permit the inference that the auditor did not actually believe that it had conducted a GAAS-compliant audit . . . when it rendered its opinions."¹⁷ One of the "red flags" that the court found "compelling" was that Ernst & Young reviewed certain reports containing "spike graphs" that suggested "Lehman's quarter- and year-end balance sheets were misleading as to its net leverage ratio by virtue of its use of [certain repurchase agreements] . . . The issue over the timing and content of [a meeting between Lehman and Ernst & Young officials] likewise present[ed] a *bona fide* factual dispute which, if resolved in plaintiffs' favor," could support the conclusion that Ernst & Young was aware that Lehman was engaging in "window dressing" on its balance sheet.¹⁸

In *In re Petrobras Securities Litigation*, the district court granted PricewaterhouseCoopers' motion to dismiss Section 10(b) claims, but declined to dismiss Section 11 claims concerning PwC's audits of the Brazilian state-owned oil company Petróleo Brasileiro

("Petrobras").¹⁹ The plaintiffs claimed that PwC failed to detect red flags concerning Petrobras' involvement "at the center of a multi-year, multi-billion dollar bribery and kickback scheme." Although the plaintiffs' Section 10(b) claim was dismissed for failing to plead scienter adequately, the court found that the complaint satisfied *Omnicare* as to the Section 11 claim by sufficiently alleging that PwC's audit opinions embedded actionable statements of fact in the form of the financial statements on which PwC opined. The court reasoned that whether a fact is "embedded" may be determined by whether the value of the opinion statements is affected if the facts in question were removed. The court explained that investors' expectation that audit opinions are based on facts stated in the financial statements forms the basis of the value of an auditor's opinion, and therefore the facts in the financial statements themselves should be considered embedded in the audits. Alternatively, even if the financial statements were not facts embedded in the audit opinions, *omitting* those facts when a reasonable investor would assume that the audit reports were based on the facts within the financial statements was another potential basis for liability. The court also rejected PwC's assertion that *Omnicare* did not extend liability to the financial statements, which consisted of estimates and assumptions, holding that treating the financial statements as opinions would counteract the aim of imposing Section 11 liability on auditors for the portion of financial statements that they certify. The court noted that "[a]n additional inference to be drawn from these allegations is that the supporting evidence PwC relied on when forming its opinion was insufficient or untrue."²⁰

In *Johnson v. CBD Energy Ltd.*, however, a district court in the Southern District of Texas disagreed with the *Petrobras* court's interpretation of *Omnicare*.²¹ *Johnson* was a purported class action brought by investors of the Australian company CBD Energy Limited ("CBD") (now known as BlueNRGY Group Limited), whose offering documents failed to disclose self-dealing transactions by one of its directors. The plaintiffs asserted Section 11 claims against the Australian PwC firm, whose audit opinions on CBD's financial statements were included in CBD's registration statement. The Texas court rejected the investors'

¹⁴No. 15-2100, 649 F. App'x 55, 2016 WL 2942415 (2d Cir. May 20, 2016).

¹⁵*Id.* at *3.

¹⁶131 F. Supp. 3d 241, 259 (S.D.N.Y. 2015).

¹⁷*Id.*

¹⁸*Id.* at 256.

¹⁹No. 14-cv-9662 (JSR), 2016 WL 1533553 (S.D.N.Y. Feb. 19, 2016).

²⁰*Id.* at *4.

²¹No. 4:15-cv-01668, 2016 WL 3654657 (S.D. Tex. July 6, 2016).

argument that, because the truth of an audit report is based on the underlying facts of financial statements, there is an “auditor” exception to the application of *Omnicare*. The court noted that *Omnicare* outlined three exceptions to its “pure statement of opinion” rule, and did not mention an additional exception for auditor certifications.²²

Addressing the investors’ argument that the audit opinions, like those in *Petrobras*, were based on “embedded statements of facts” contained in the CBD financial statements, the court concluded that the *Petrobras* court misunderstood *Omnicare*’s idea of “embedded statement of facts” because the audit opinions in dispute were not based on an “underlying, verifiable fact” that appears in the audit report itself.

“The numbers in CBD’s financial statements,” the court explained, “are not ‘embedded’ in a subordinate clause in any of PwC Australia’s sentences in the way the *Omnicare* Court set out.”²³ Holding that the plaintiffs’ allegations failed to satisfy *Omnicare*, the court dismissed the Section 11 claims with prejudice.

CONCLUSION

As the Supreme Court’s analysis in *Omnicare* has worked its way through the lower courts, the decision has appeared less like a magic bullet and more like an additional tool in the toolbox that, in the right circumstances, may be used as part of a successful defense against Section 11, Section 10(b), and Section 18 claims against auditors. ■

²² *Id.* at *10.

²³ *Id.* at *12.