Auditor Liability For Securities Fraud After The PSLRA And Sarbanes-Oxley

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A. Introduction


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found “systemic and catastrophic failure” by the SEC in its regulation of Enron, stating, in its final report, that “[w]e have witnessed a fundamental breakdown in this system.” Jonathan Weil and John Wilke, *Senate Panel Chides SEC for Falling Short in Enron Regulation*, Wall St. J., Oct. 7, 2002, at C1. Senators Joseph Lieberman and Fred Thompson, in an October 2002 letter to Pitt, claimed, “[T]he investing public expects and deserves more meaningful protection from the ultimate market watchdog.” *Id.* Meanwhile, the PSLRA—significant legislation in and of itself—continues to be the catalyst for judicial interpretation. Auditors must now face the significant changes in the regulatory landscape wrought by Sarbanes-Oxley as well as a charged environment in which the SEC and others increasingly view independent auditors as prime targets.

B. Case Developments After PSLRA

1. *Pleading Requirements.* The Reform Act requires that in any private securities fraud action in which the plaintiff is alleging a misleading statement or omission on the part of the defendant, “the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.” 15 U.S.C. §78u-4(b)(1).

   a. The Reform Act also requires that “[i]n any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. §78u-4(b)(2).

   b. This statement represents a departure from the pre-Reform Act standard of Federal Rule of Civil Procedure 9(b), which requires that fraud be alleged with particularity but expressly allows “malice, intent, knowledge and other condition of mind of a person to be averred generally.”

   c. Although the Reform Act states that scienter should be pled with particularity, the Reform Act does not define scienter or indicate the standards for alleging scienter, and post-Reform Act judicial decisions have formulated different interpretations of how the scienter requirement can be satisfied.
d. Before the Reform Act, the Court, in *Ernst & Ernst v. Hochfelder, Inc.*, 425 U.S. 185, 193 n.12 (1976), held that “scienter,” which it defined as “a mental state embracing intent to deceive, manipulate, or defraud,” was a prerequisite to fraud liability under section 10(b) and Rule 10b-5.

i. The Hochfelder court expressly rejected the plaintiff’s contention that the defendant’s accountants could be liable under section 10(b) and Rule 10b-5 based solely on their negligence.

ii. However, the court left open the question of whether recklessness could satisfy the scienter requirement.


f. With regard to accountants, the recklessness standard has been stated in various ways:

i. *In re Lernout & Hauppie Securities Litigation*, 230 F. Supp. 2d 152, 160 (D. Mass. 2002) (quoting Raytheon, 157 F. Supp. 2d at 154) (“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 decision if confronted with the same facts. 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.”);

ii. *In re Raytheon Securities Litigation*, 157 F. Supp. 2d 131, 154 (D. Mass. 2001) (quoting Rothman v. Gregor, 220 F.3d 81, 98 (2d Cir. 2000)) (“For recklessness on the part of a non-fiduciary accountant to satisfy securities fraud scienter, such recklessness must be conduct that is highly unreasonable, representing an extreme departure from the standards of ordinary care. It must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company.”);
iii. *In re Software Toolworks, Inc. Securities Litigation*, 50 F.3d 615, 627-28 (9th Cir. 1994) (considering alleged gross departures from GAAP or GAAS as merely negligent actions that do not meet the scienter requirement); and


g. The Reform Act, along with its legislative history, left the definition of scienter as an open question to be defined by the courts. One dispute has centered on whether Congress intended to adopt the Second Circuit’s standard or whether it intended to require even more.

i. Today, the Second Circuit has established the most liberal pleading standard. *See Novak v. Kasaks*, 997 F. Supp. 425, 429-30 (S.D.N.Y. 1998), *vacated and remanded*, 216 F.3d 300 (2d Cir. 2000), *cert denied*, 531 U.S. 1012 (2000) (ruling that a plaintiff claiming fraud need only plead that the defendant had “motive and opportunity,” a standard that can be met, for example, by alleging stock stales by corporate executives before a surprise announcement that causes stock prices to drop).

ii. The Ninth Circuit, on the other hand, has articulated the most stringent standard. *See In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999) (requiring pleadings to provide “in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct”).

h. The heightened pleading requirement of the Reform Act is particularly difficult to meet in cases brought against auditors. A developing line of Reform Act cases recognizes that it is more difficult to plead scienter with respect to independent auditors than to corporate insiders. Courts have often dismissed securities fraud complaints against auditors even when the complaints have adequately pled claims alleging accounting improprieties against the auditors’ client.

i. Courts have found that auditors warrant different treatment from corporate insiders for purposes of pleading scienter because they have less to gain (in terms of stock options or fees) and more to lose (in terms of their professional reputation) than do corporate insiders. *See Reiger v. Price Waterhouse Coopers LLP*, 117 F. Supp.2d 1003, 1008 (S.D. Cal. 2000), *aff’d* 288
F.3d 385 (9th Cir. 2002) (“[T]he lack of a rational economic incentive for an independent accountant to participate in fraud, the client’s central role in providing information to the accountant, and the complex professional judgment required to perform an audit, make it exceedingly difficult for a securities plaintiff to plead facts suggesting that an independent accountant acted with the deliberate state of mind now required to withstand a motion to dismiss.”); DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990) (pre-Reform Act) (“An accountant’s greatest asset is its reputation for [integrity and] honesty, followed closely by its reputation for careful work. Fees for two years’ audits could not approach the losses [defendant] would suffer from a perception that it would muffle [the] client’s fraud.”).

However, these conclusions may be questioned in the post-Enron age. In In re Enron Corp. Securities, Derivative & ERISA Litigation, 235 F. Supp. 2d 549 (S.D. Tex. 2002), the court detailed Arthur Andersen’s struggle to decide whether to stand up to Enron and thereby risk losing its largest client. Ultimately, the court concluded that Arthur Andersen determined that Enron’s business was too valuable to risk. Cases dismissing a complaint against an auditor while holding that the complaint adequately pled a claim for accounting violations against an audit client include:

i. Rothman v. Gregor, 220 F.3d 81, 98 (2d Cir. 2000) (affirming dismissal of securities class action complaint as to independent auditors while reversing dismissal as to company and its insiders);

ii. In re Westinghouse Securities Litigation, 90 F.3d 696, 712-13 (3d Cir. 1996) (pre-Reform Act) (affirming dismissal of complaint against independent auditors while reversing certain aspects of dismissal against company defendants);

iii. In re Raytheon Securities Litigation, 157 F. Supp. 2d 131 (D. Mass. 2001) (dismissing complaint alleging accounting improprieties as to auditors but sustaining complaint as to audit clients); and

iv. In re Wellcare Management Group, Inc. Securities Litigation, 964 F. Supp. 632, 640 (N.D.N.Y. 1997) (sustaining complaint against management for, among other things, fraudulent violation of GAAP; although complaint alleged auditor’s violations of GAAS, such allegations at best constituted negligence—the facts failed to show that the auditor’s conduct “approximate[d] an actual intent to aid in the fraud being perpetrated by the audited company”).