Auditor Liability: Institutional Investors Pursue Opt-Out Actions to Maximize Recovery of Securities Fraud Losses

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Little more than eleven years after the passage of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), the winds of "reform" are stirring again. While avenues for investor recovery from auditor defendants remain open, a series of recent attacks have been mounted to limit auditor liability in class actions initiated under the federal securities laws. In response, will this drive even more institutional investors to opt-out of traditional securities class actions to pursue individual actions against auditor defendants? Given the right circumstances, opt-out litigation potentially provides institutional investors with a powerful set of state law claims with broader scopes of liability and remedies to assert against auditor defendants beyond that provided under the federal securities laws. We survey these benefits and the potential for even more institutional

investors to opt-out of class action securities litigation to pursue direct claims against auditor defendants.

Auditors Lobby for Liability Limitations in the Wake of Massive Financial Frauds

The message is clear – auditors are intent on limiting their liability for securities fraud and are heavily lobbying Congress, the White House, and business organizations to make this happen. Within the last twelve months, there have been no less than three reports calling for additional limitations on investors' rights to recover damages through civil litigation against auditor defendants.[2] Recommendations for limiting auditor liability include capping damages, creating safe harbors from liability for certain audit work and forcing the arbitration of claims.[3]

The reason auditing firms seek to limit their liability is obvious – auditors stood in the eye of the storm in connection with the largest corporate meltdowns in recent history due to massive financial fraud and failed to perform as gatekeepers for investors. Indeed, auditor defendants were

named in the top four largest securities class action settlements to date.[4] And, in 2006 alone, 68% of federal securities actions alleged violations of Generally Accepted Accounting Principles ("GAAP").[5]

Although the recent calls for limiting auditor liability are in the advocacy stage, institutional investors may increasingly shift their efforts to individual actions alleging state law violations in order to broaden claims and remedies to pursue damages from auditor defendants rather than accept limits on auditor liability under the federal securities laws.

Pleading Auditor Fraud

Rigorous Federal Standards

In addition to the rising calls for limited auditor liability, the pleading standards with respect to § 10(b) actions initiated under the Securities Exchange Act of 1934 ("Exchange Act") are shifting. Recently, the Supreme Court introduced a new standard for pleading scienter in the *Tellabs* decision.[6] In *Tellabs*, the Supreme Court clarified the test that courts must apply to determine whether a complaint

pleads a "strong inference" of scienter as required by § 21D(b)(2) of the PSLRA.[7] The Supreme Court held that "[a] complaint will survive [a motion to dismiss]… if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[8] Accordingly, on a motion to dismiss, it is a defendant's burden to establish that the inference of non-culpable conduct is stronger than the inference of scienter raised by a plaintiff.

Although the *Tellabs* standard imposes no greater burden on plaintiffs than before (and is a less rigorous standard than previously imposed by the Ninth Circuit Court of Appeals), the case does not involve an auditor defendant.[9] This will give rise to greater challenges by auditor defendants as to what constitutes non-culpable inferences warranting dismissal in connection with routine, or even specialized, audit functions. As such, courts may come to differing conclusions as to what constitutes acceptable non-culpable inferences for auditor defendants.

Adding to this uncertainty with respect to auditor defendants, the Supreme Court is set to rule next term on the applicability of scheme liability to § 10(b) cases in the *Stoneridge* case.[10] In *Stonebridge*, the question presented is:

> Whether this Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), forecloses claims for deceptive conduct under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b- 5(a) and (c), 17 C.F.R. 240.10b-5(a) and (c), Respondents engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where Respondents themselves made no public statements concerning those transactions.[11]

As with *Tellabs*, the *Stoneridge* case does not involve an auditor defendant. Even if the Supreme Court were to endorse a theory of scheme liability – as contemplated by the statute – the applicability of auditor-specific conduct will remain untested for the immediate future.

Indeed, prior to either *Tellabs* or *Stoneridge*, many federal courts insisted on a heightened pleading standard with

respect to auditor defendants that went beyond anything prescribed for non-auditor defendants. In upholding the dismissal of a securities fraud class action complaint, the Seventh Circuit held that "[a]n accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. … It would have been irrational for any of [the auditors] to have joined cause with [their audit client to commit fraud]."[12] One district court in the Seventh Circuit then went so far as to hold that "in the absence of evidence that an outside accountant has become an insider in the subject company, *e.g.*, by purchasing stock whose value is then inflated by the misstatements, it appears unlikely for any plaintiff ever to demonstrate sufficient motive to provide a strong inference pursuant to the motive and opportunity test that an outside accountant or accounting firm committed fraud."[13]

The Second Circuit subsequently defined reckless behavior evidencing scienter with respect to an auditor as "conduct that is highly unreasonable, representing an extreme

departure from the standards of ordinary care."[14] The Ninth Circuit raised the bar even higher with respect to auditors and held that to meet the PSLRA's pleading standard for auditor conduct, plaintiffs must plead particular facts showing 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."[15] Indeed, the Ninth Circuit went on to hold that "[m]ere allegations that an accountant negligently failed to closely review files or follow GAAP cannot raise a strong inference of scienter."[16]

Given the shifting landscape and rigorous standards for pleading scienter and scheme liability under § 10(b) of the Exchange Act, in certain cases, institutional investors may find litigating opt-out claims in state court more productive. Indeed, the progeny of cases requiring a heightened pleading standard for auditor defendants are

irrelevant with respect to state law claims that require a plaintiff to plead and prove their claims against an auditor defendant under less rigorous liability standards.[17]

Opt-Out Litigation Against Auditors

Institutional Investors Assert Broader Claims and Remedies Under State Law

One of the dominant benefits in bringing an opt-out action is the availability of state law causes of action with broad standards of liability.[18] These various claims generally prohibit larger categories of conduct than federal securities claims under either § 10(b) of the Exchange Act or § 11 under the Securities Act of 1933 ("Securities Act"). While auditor liability in connection with federal securities claims is generally limited to the issuance of false financial statements within a relevant period, several important state law claims provide for liability well beyond this limitation.[19] Indeed, many state law claims, such as equivalent Racketeer Influenced Corrupt Organizations Act ("RICO") statutes, as well as, misrepresentation and common law fraud, prohibit

entire categories of fraudulent conduct outside the mere preparation and dissemination of company financials. These claims are generally unavailable to plaintiffs in the class context.[20]

The ability to allege state law causes of action in opt-out litigation is important for several reasons beyond the obvious expanded liability provisions. Indeed, the standard for alleging and proving liability under these state statutes is generally less onerous than with similar federal claims.[21] In addition, these broader liability standards provide investors with greater latitude in alleging and proving loss causation. In some circumstances certain claims even presume loss causation. Likewise, with a host of fraudulent conduct applicable to auditors under state law, legally recognized damages necessarily increase.[22] Further, opt-out litigation comes with greater forum choices which generally allow subsequent trials in jurisdictions more favorable to investor plaintiffs.[23]

Given these favorable advantages, particularly in situations where the auditor is in the eye of the storm, individual opt-out litigation involving auditors appears to be on the rise. Indeed, opt-out litigants initiated actions against auditors in cases against Tyco, Ltd. (naming PricewaterhouseCoopers ("PwC")), AOL Time Warner, Inc. (naming Ernst & Young LLP) and Qwest (naming Arthur Anderson LLP).

The availability of state claims has already shown to be beneficial. For example, this year the State of New Jersey, Department of Treasury, Division of Investments, survived a motion to dismiss its New Jersey Racketeer Influenced Corrupt Organizations Act ("NJRICO") claims against an auditor defendant (PwC) in the Tyco opt-out action pending in the United States District Court of New Hampshire.[24] This is an important decision given that RICO claims are unavailable to plaintiffs in the class context under the PSLRA.[25] Moreover, the NJRICO claims allow for treble damages against PwC related to its conduct.[26] This trend

does not appear to be slowing, and the results demonstrate the benefits of these types of actions.[27]

Loss Causation and Damage Considerations

Another important reason that state law claims appeal to investor plaintiffs seeking to recover from auditor defendants is the presumption of loss causation which is unavailable with respect to § 10(b) claims.[28] The requirement to plead and prove loss causation derives from the PSLRA, and applies to all securities claims arising under § 10(b) of the Exchange Act.[29] In *Dura Pharm., Inc. v. Broudo*, the Supreme Court reviewed the Ninth Circuit's decision that in a fraud on the market case, an allegation of simple "price inflation" by itself, when a plaintiff purchases securities, is sufficient to show loss – even if the plaintiff sold the stock at a profit, before any ill effects related to fraud came to pass.[30] The Supreme Court reversed, holding that "as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at

that instant possesses equivalent value."[31] At the pleading stage, *Dura* holds that "it should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind."[32] Loss causation is ultimately established when the plaintiff "prove[s] that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss."[33] Declining to define the parameters of such proof, the Supreme Court acknowledged that investors can prove the economic loss was suffered when a stock's price declines as "the truth makes its way into the market place."[34]

In contrast to federal securities claims, many state statutes and precedents set out their own schemes of liability and damages, quite distinct from – and often contrary to – *Dura*'s rule for federal § 10(b) claims. For example, violations of the California Corporations Code do not require proof of causation.[35] "[D]amages shall be the difference between the price at which such other person purchased or

sold securities and the market value which such securities would have had at the time of his purchase or sale in the absence of such act or transaction, plus interest at the legal rate."[36] The California Legislature has thus defined damage recovery in terms of inflation at the time of purchase – the very measure the Supreme Court in *Dura* rejected for fraud on the market cases under § 10(b).

Similarly, California fraud claims, codified in California Civil Code §§ 1572, 1573, 1709, and 1710, are distinct from federal securities fraud claims, both with respect to elements of liability, and in the rules governing recoverable damages. *Dura* is not persuasive authority as to the elements of those claims, because its derivation and purposes are different. For example, under California Civil Code § 1572, plaintiffs are entitled to recover all damages for which defendants are a "substantial factor" in causing, whether or not such harm could have been anticipated.[37] This "substantial factor" standard is broader than that under § 10(b), where a plaintiff's damages are limited to forseeable

losses.[38] Indeed, § 1709 has been held to allow for restitutional loss.[39] Moreover, damages under this statute include the amount which will compensate the plaintiff for all the detriment caused thereby, whether it could have been anticipated or not.[40] Clearly, such state provisions present a measure of liability exposure to auditor defendants unseen in federal securities class actions.

Conclusion

Audit firms are lobbying to restrict their liability under the federal securities laws and federal courts have raised the bar for pleading and proving securities fraud against auditors. In turn, institutional investors have responded by increasingly pursuing opt-out litigation against auditors. This is not entirely surprising. State law claims available to opt-out litigants typically offer broader remedies with less rigorous pleading and proof hurdles. Thus, while auditing firms often escape securities fraud liability under federal law, opt-out litigation initiated by institutional investors ensures that audit firms are held accountable.

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[2] Interim Report of the Committee on Capital Markets Regulation, 14 (November 30, 2006) (recommending cap on damages or a safe harbor from liability for certain audit practices); Sustaining New York's and the US' Global Financial Services Leadership, 20 (January 2007) (recommending arbitration of claims and "a cap on auditor's damages"); U.S. Chamber of Commerce, Commission on the Regulation of U.S. Capital Markets in the 21st Century, Report and Recommendations, 171 (March 2007) (recommending a cap on damages for auditors citing "[c]atastrophic litigation claims in a market in which commercial insurance simply is not available to the firms in adequate amounts to cover such claims.").

[3] *Id*.

[4] The four largest securities class action settlements to date include Enron Corp. (partial settlement of $7.14 billion), WorldCom, Inc. ($6.15 billion), Cendant Corp. ($3.56 billion) and AOL Time Warner, Inc. ($2.65 billion).

[5] Cornerstone Research, Securities Class Action Case Filings 2006: A Year in Review, 3 (2006).

[6] *Tellabs, Inc. et al. v. Makor Issues & Rights, LTD., et al.,* 551 U.S. ___ (2007).

[7] *Id*. at 1-2.

[8] *Id*. at 12-13.

[9] In alleging scienter, the Ninth Circuit required plaintiffs to plead "particular facts giving rise to a strong inference of deliberate or conscious recklessness." *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999).

[10] *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* (06-43).

[11] *Id*.

[12] *DiLeo v. Ernst & Young*, 901 F.2d 624, 626 (7th Cir. 1990).

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[13] *Retsky Family L.P. v. Price Waterhouse LLP*, No. 97 C 7694, 1998 WL 774678, *9 n.2 (N.D. Ill. Oct. 21, 1998).

[14] *Rothman v. Gregor*, 220 F.3d 81, 90 (2d Cir. 2000).

[15] *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir. 2002) (citation omitted).

[16] *Id*.

[17] *See, e.g., Kouri v. Superior Court*, 148 Cal. App. 4th 460, 468 (2007) (reversing trial court's dismissal of misrepresentation claim holding that "blatant deviations from GAAP support an inference of an accountant's recklessness when those deviations are tantamount to 'red flags.'").

[18] The availability of specific state law causes of action in opt-out litigation largely depends on the ability to toll claims based upon an earlier-filed class action. *See American Pipe & Constr. Co. v. Utah*, 414 U.S. 538 (1974). This is a fact-intensive process that relies upon the application of "cross jurisdictional tolling" to particular state claims.

[19] In the federal context, there has been some success in alleging liability for auditors beyond audited financial statements. *See, e.g., Wright v. Ernst & Young LLP*, 152 F. 3d 169, 177 (2d Cir. 1998) (auditors "do have a duty to take reasonable steps to correct misstatements they have discovered in previous financial statements on which they know the public is relying") (citations omitted); *see also SEC v. Manor Nursing Centers Inc.*, 458 F.2d 1082, 1095 (2d Cir. 1972) ("[p]ost-effective developments which materially alter the picture presented in the registration statement must be brought to the attention of public investors"); *In re Ikon Office Solutions, Inc. Sec. Litig.*, 66 F. Supp. 2d 622, 636 (E.D. Pa. 1999) (auditor required to perform subsequent events review through effective date of registration statement).

[20] Section 107 of the PSLRA amends 18 U.S.C. § 1964(c) such that a person injured by reason of a violation of RICO may sue except that no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of RICO. Moreover, as discussed, § 10(b) requires pleading a "strong inference" of scienter which cannot be accomplished through allegations of mere negligence. *Tellabs* at 11-13.

[21] Section 11 expressly provides a right of action to "any person acquiring" a security issued pursuant to a registration statement that "contain[s] an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. §77k(a). Indeed, any "untrue statement of a material fact" leads to liability for the issuer, §11(a), and for every other signer who cannot make out a due diligence or expertise defense, §11(b). *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 383, 74 L. Ed. 2d 548, 103 S. Ct. 683 (1983). Although claims under § 11 provide for strict liability, these are limited to a defined set of false statements in, or incorporated by reference in, offering documents and a due diligence defense is available to auditor defendants, as compared to issuer defendants.

[22] Indeed, while federal precedent prohibits awards of punitive damages on § 10(b) claims, *Ryan v. Foster Marshall, Inc.*, 556 F.2d 460, 464 (9th Cir. 1977), California law permits punitive awards for claims under Civil Code § 1572. *Godfrey v. Steinpress*, 128 Cal. App. 3d 154, 182 (1982). Moreover, in cases of constructive fraud under § 1573, a plaintiff is entitled to recover the difference between the actual value of that parted with and received, together with any additional damages arising from the transaction. *Sixta v. Ochsner*, 187 Cal. App. 2d 485, 491 (1961) (citing Cal. Civ. Code § 3343).

[23] Even if an action is consolidated as part of The Judicial Panel on Multidistrict Litigation, "[e]ach action so transferred shall be remanded by the panel at or before the conclusion of such pretrial proceedings to the district from which it was transferred unless it shall have been previously terminated." 28 U.S.C. § 1407(a); *see also Lexecon Inc. v. Milberg Weiss Bershad Hynes & Lerach,* 523 U.S. 26, 43 (1998).

[24] *In re Tyco International, Ltd., Multidistrict Litigation*, 2007 U.S. Dist. LEXIS 42401 (D. N.H. June 11, 2007).

[25] *Supra*, n.16.

[26] N.J. Stat. Ann. § 2C:41-4(c).

[27] Indeed, The Regents of the University of California recently reported the "largest publicly announced payment on an opt-out securities claim in history" against AOL Time Warner, Inc. for $246 million. *UC Regents to vote on $246 million settlement of AOL/Time-Warner securities litigation*,

Feb. 8, 2007, at http://www.universityofcalifornia.edu/news/2007/feb28.html

[28] Contrary to § 10(b) claims, where a plaintiff has the burden of proving loss causation, causation is not even an element of plaintiffs' *prima facie* case under § 11 – causation is presumed. 15 U.S.C. § 77k(e). Plaintiffs need not establish the extent or cause of any price inflation or subsequent decline. "Unlike claims under §10(b), under §11 a plaintiff generally does not have to establish scienter, causation (materiality) or reliance." *In re Enron Corp. Securities, Derivative & "ERISA" Litig.*, No. H-01-3624, 2005 U.S. Dist. LEXIS 39927, *75 (S.D. Tex. Dec. 5, 2005).

[29] 15 U.S.C. §78u-4(b)(4).

[30] 544 U.S. 336 (2005).

[31] *Id*. at 341.

[32] *Id*. at 347.

[33] *Id.* at 346.

[34] *Id.* at 342.

[35] *Bowden v. Robinson*, 67 Cal. App. 3d 705, 715 (1977) ("Sections 25401 and 25501 differ from common law negligent misrepresentation in that: (1) proof of reliance is not required, (2) although the fact misrepresented or omitted must be 'material,' no proof of causation is required, and (3) plaintiff need not plead defendant's negligence."). Similarly, several federal courts have already held that *Dura* does not govern claims under the Securities Act. *See, e.g., Freeland v. Iridium World Communs., Ltd.*, 233 F.R.D. 40, 46-47 (D.D.C. 2006); *In re WRT Energy Sec. Litig.*, 2005 U.S. Dist. LEXIS 31280, *3-*4 (S.D.N.Y. Dec. 1, 2005).

[36] Cal. Corp. Code § 25500.

[37] 1-1900 CACI 1923 & 1924; *Walker v. Signal Cos., Inc.*, 84 Cal. App. 3d 982, 995 (damages for fraud are an "amount which will compensate for all the detriment caused thereby, whether it could have been anticipated or not"). Sections 1709 and 1710 similarly provide a more liberal rule of recovery for fraud or deceit than that provided under §

10(b). Section 1709 states, "[o]ne who willfully deceives another with intent to induce him to alter his position to his injury or risk, is liable for any damage which he thereby suffers." Cal. Civ. Code § 1709. Thus, similar to §§ 1572 and 1573, under § 1709 a defendant who willfully deceives investors by inducing them to purchase a security is liable for "any damage" that a plaintiff suffers. This form of recovery entitles a plaintiff to either a "benefit of the bargain" or "out-of-pocket" remedy. 1-1900 CACI 1923 & 1924. The "out-of-pocket" measure of damages "is directed to restoring the plaintiff to the financial position enjoyed by him prior to the fraudulent transaction, and thus awards the difference in actual value at the time of the transaction between what the plaintiff gave and what he received." *Stout v. Turney*, 22 Cal. 3d 718, 725 (1978). "The 'benefit-of-the-bargain' measure, on the other hand, is concerned with satisfying the expectancy interest of the defrauded plaintiff by putting him in the position he would have enjoyed if the false representation relied upon had been true; it awards the difference in value between what the plaintiff actually received and what he was fraudulently led to believe he would receive." *Id.* (*citing Overgaard v. Johnson*, 68 Cal. App. 3d 821, 823 (1977)).

[38] *Lentell v. Merrill Lynch*, 396 F.3d 161, 173 (2nd Cir. 2005) (loss causation requires "that the loss be foreseeable").

[39] *Roberts v. Ball, Hunt, Hart, Brown & Baerwitz*, 57 Cal. App. 3d 104, 111 (1976) ("Civil Code section 1709 states that damage recoverable by a plaintiff in a deceit case is 'any damage which he thereby suffers' as a result of the deceit. This damage rule for deceit allows for an out-of-pocket, *i.e.*, restitutional, loss.").

[40] *Supra*, n.36.