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Defending Auditors at the Pleading Stage

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I. Introduction

The collapse of the subprime mortgage market in 2007 and the ensuing financial turmoil has set off a wave of litigation. As with past market crises, plaintiffs seeking the largest possible recovery have sued auditors[1] alleging violations of federal securities laws[2] and auditor malpractice.[3] Even when the auditor is not initially named as a defendant, an audit client facing potentially significant liability may in turn sue its auditors for malpractice as a defense strategy or in an attempt to mitigate the client's exposure.[4] Once an audit client enters bankruptcy, a variety of claimants— including successors-in-interest—may seek recovery from the auditor.[5]

To avoid the high cost of protracted litigation, auditors and their counsel often move to dismiss claims at the outset of a case. Accordingly, this article discusses several recent developments that have strengthened the defenses available to auditors at the pleadings stage. Our review is primarily focused on New York state and federal case law because it is well-developed in the area of auditor liability, and because many lawsuits related

[1] The term ''auditor'' and ''auditors'' is used throughout this article to refer to both certified public accountants and public accounting firms in their role as independent auditors. We refer to auditors, rather than accountants, because there are separate issues regarding liability for non-audit services that are beyond the scope of this article.

[2] *See, e.g.*, *In re New Century*, 588 F. Supp. 2d 1206 (C.D. Cal. 2008); *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132 (C.D. Cal. 2008); *In re Ambac Fin. Group, Inc. Sec. Litig.*, No. 08-00411 (NRB), 2008 U.S. Dist. LEXIS 38729 (S.D.N.Y. May 9, 2008).

[3] *See, e.g.*. *In re The New Century Liquidating Trust v. KPMG LLP*, No. BC410846 (Cal. Apr. 1, 2009).

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[4] *See generally* Thom Weidlich, *Madoff Feeder Sues Own Auditors for Not Finding Fraud*, Bloomberg (Feb. 2, 2009) (referring to auditor malpractice suit as ''a preemptive, Don Quixote strike against the accounting firms to attempt to absolve the principals of liability.'').

[5] *See, e.g.*, Samuel C. Wasserman, *Can the Trustee Recover? Imputation of Fraud to Bankruptcy Trustees in Suits Against Third-Party Service Providers*, 77 FORDHAM L. REV. 365, 367 (Oct. 2008) (referring to professional advisors, including auditors, as ''appealing targets because they tend to have more resources than the now-bankrupt corporation and are therefore more likely to be able to pay damage awards.''); *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 401 (Cal. S. Ct. 1992) (''[W]hen clients fail financially, the CPA auditor is a prime target in litigation claiming investor and creditor economic losses because it is the only available (and solvent) entity[.]'').

to the financial crisis have been filed in New York state or federal courts.

II. Defending Against Claims By Investors

A. Securities Exchange Act of 1934

Investors regularly sue auditors for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 (''Exchange Act'') and Rule 10b-5.[6] In such cases, the plaintiff class consists of anyone who purchased or sold the audit client's securities while the price was ''artificially inflated'' by the defendants' alleged fraud.[7] Plaintiffs bringing a 10b-5 claim must allege that the defendant made a material misstatement, with scienter, in connection with the purchase or sale of a security, that the plaintiff relied on, causing damages to the plaintiff.[8]

The Private Securities Litigation Reform Act (''PSLRA'') is the chief bulwark against such claims.[9] Most significantly, the PSLRA imposes heightened pleading requirements on Exchange Act securities fraud claims.[10] Specifically, the PSLRA requires a plaintiff to ''state with particularity both the facts constituting the alleged violation, and the facts evidencing scienter, *i.e.*, the defendant's intention 'to deceive, manipulate, or defraud.' ''[11]

Congress imposed the PSLRA's heightened pleading requirementsin order ''to deter the filing of frivolous securities fraud lawsuits and to curb the practice of suing 'deep pocket defendants, including accountants [. . .] who may be covered by insurance, without regard to their actual culpability.' ''[12] To that end, the PSLRA requires dismissal of claims that fail to meet these pleading requirements, and stays discovery pending resolution of any motion to dismiss.[13] Securities fraud cases can thus be dismissed pre-discovery for failure to meet the PSLRA's pleading requirements.[14]

1. Material Misstatement

Pleading a material misstatement under the PSLRA requires that the plaintiff identify the specific alleged misstatement and why that statement was false or misleading when made.[15] In addition, to the extent plaintiff's allegations are based on ''information and belief,'' the complaint must ''state with particularity all facts on which that belief is formed.''[16] Moreover, a misstatement is not actionable unless made directly by or attributed to the defendant.[17] Accordingly, a plaintiff must identify an alleged material misstatement made by the auditor, and cannot simply refer to alleged misstatements in the audit client's financial statements.[18]

Plaintiffs fail to state a 10b-5 claim to the extent they allege that an auditor merely assisted or participated in the preparation of an audit client's misleading financial statements. As the Supreme Court long ago held in *Central Bank of Denver* and recently reaffirmed in *Stoneridge*, there is no private liability for aiding and abetting securities fraud.[19] Indeed, well before *Stoneridge*, the Second Circuit noted that ''if *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).''[20]

The audit report typically contains the only statements attributed to the auditor.[21] Plaintiffs therefore normally allege that the audit report contains material misstatements that the audit was conducted in accordance with Generally Accepted Auditing Standards (''GAAS''), or that the audit provided a reasonable basis for the auditor's opinion that the audited financial statements were prepared in conformity with Generally Accepted Accounting Principles (''GAAP'').[22] In support of these allegations, securities fraud complaints often include a ''laundry list'' of alleged GAAS and GAAP violations.[23] However, such generalized allegations do not meet the PSLRA's pleading requirements.[24]

Auditors may be tempted to defend against 10b-5 claims by proving that the audit was, in fact, conducted

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[6] *See, e.g.*, Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession*, at VII:27 (Oct. 6, 2008) (''Claims today in securities class actions can be significant multiples of the capital of even the largest auditing firms.''); Eric L. Talley, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 COLUM. L. REV. 1641, 1650 (Nov. 2006) (''Not only does this source of liability capture a significant fraction of the national headlines, but it is perhaps the most significant monetary source of exposure for dominant [audit] firms today.'').

[7] *See, e.g.*, Sanford P. Dumain, *Class Action Suits, Auditor Liability, and the Effect of the Private Securities Litigation Reform Act of 1995*, Accountants' Liability, ALI-ABA Course of Study Materials at 158 (July 9-10, 2009).

[8] *See, e.g.*, Mathew R. King, Elizabeth Corrigan and Craig Francis Dukin, *Securities Fraud*, 46 AM. CRIM. L. REV. 1027, 1030-31 (Spring 2009).

[9] *See generally* Dan L. Goldwasser et al., ACCOUNTANTS' LIABILITY §§1:4.6(A), 5:2 (2007).

[10] 15 U.S.C. §78u-4(b) *et. seq.*

[11] *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 (1976)).

[12] *Reiger v. PriceWaterhouseCoopers LLP*, 117 F. Supp. 2d 1003, 1007 (S.D. Cal. 2000) (quoting H.R. Conf. Rep. No. 104-369, at 31 (1995)).

[13] 15 U.S.C. §78u-4(b)(3)(A) and (B). The stay of discovery is subject to limited exceptions, upon motion by either party, to ''preserve evidence or prevent undue prejudice.'' *Id.* at (B).

[14] *See, e.g.*, Thomas J. Hall & Thomas J. McCormack, *Financial Meltdown Triggers Litigation Wave*, N.Y.L.J. (Jan. 5, 2009) (referring to the PSLRA's scienter pleading requirement as ''the most ubiquitous conventional stumbling block for plaintiffs alleging securities fraud[.]'')

[15] 15 U.S.C. §78u-4(b)(1)(B).

[16] *Id.*

[17] *Wright v. Ernst & Young LLP*, 152 F. 3d 169, 175 (2d Cir 1998).

[18] *Id.*

[19] *Stoneridge Inv. Partners LLC v. Scientific-Atlanta Inc.*, 128 S. Ct. 761, 768 (re-affirming the holding in *Central Bank* ''that §10(b) liability did not extend to aiders and abettors'') (citing *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994)).

[20] *Wright*, 152 F.3d at 175.

[21] *See, e.g.*, Christine M. Hoffman and Matthew C. Baltay, *Auditor Liability in Securities Litigation from a Defense Perspective*, Securities Litigation: Planning and Strategies, ALI-ABA Course of Study Materials 617, 620 (May 1-2, 2008).

[22] *Id.*

[23] *Id.* at 630-31 (listing cases)

[24] *Id.*

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in accordance with the highest professional standards and that the interpretations of GAAP were well-supported and reasonable. This defense may even seem easily proven, given that there are audit files and work-papers documenting all of the work performed and the conclusions reached. However, proving compliance with GAAS is very fact-intensive and technical, and often requires extensive discovery including expert testimony.[25]

Moreover, even after discovery, plaintiffs need only sufficiently contest the auditor's compliance with GAAS to create an issue of fact in order to defeat a motion for summary judgment.[26] For example, courts have found that conflicting expert testimony is sufficient to create an issue of fact that must be decided at trial, regardless of the relative credibility of the experts.[27] For these reasons, litigating GAAS compliance is an expensive proposition, and thus presumptively less appealing than a defense that can be decided on a pre-discovery motion to dismiss.

2. Scienter

Courts frequently dismiss securities fraud actions against auditors for failure to adequately plead scienter as required by the PSLRA.[28] For any claim requiring proof of a particular state of mind, plaintiffs must ''state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.''[29] Plaintiffs may plead scienter by alleging facts ''(1) showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness.''[30]

Pleading motive and opportunity against an auditor is typically very difficult. Allegations that an auditor desired to continue a profitable business relationship with an audit client are insufficient to show improper motive.[31] Indeed, New York federal courts in particular have consistently recognized that auditors have little economic incentive to participate in an audit client's fraud.[32]

Plaintiffs may alternatively attempt to plead an auditor's scienter based on recklessness. This standard is also difficult to meet as it requires ''conduct that is highly unreasonable, representing an extreme departure from the standards of ordinary care. [The auditor's conduct] must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company.''[33] Courts frequently grant auditors' motions to dismiss on the ground that the plaintiffs' allegations amount at most to negligence, not recklessness or fraudulent intent.[34] For example, courts have repeatedly held that ''[t]he mere misapplication of accounting principles by an independent auditor does not establish scienter.''[35]

Recently, the Supreme Court interpreted the strong inference of scienter pleading standard in *Tellabs v. Makor*.[36] The Supreme Court held that, in order to adequately plead a strong inference of scienter, the ''inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent.''[37] Lower courts have already noted that *Tellabs* has further heightened the standard for pleading scienter, and dismissed plaintiffs' claims against auditors for failure to meet that standard.[38]

B. Securities Act of 1933

In addition to the private actions available under the Exchange Act, investors may also bring claims against

[25] *See, e.g.*, *Kemmerlin v. Wingate*, 274 S.C. 62, 65 (1979) (''Since [an accountant's duty of care] is an area beyond the realm of ordinary lay knowledge, expert testimony usually will be necessary to establish both the standard of care and the defendant's departure therefrom.''); *First Nat'l Bank v. Crawford*, 182 W. Va. 107, 112 (W. Va. 1989) (''As in most cases involving the question of professional malpractice, the issue is ordinarily resolved through expert testimony.'').

[26] *Cumis Ins. Soc'y, Inc. v. Tooke,* 739 N.Y.S.2d 489, 494 (reversing summary judgment because plaintiff's expert, although not viewed as credible by the lower court, created an issue of fact regarding compliance with GAAS).

[27] *In re WorldCom, Inc. Secs. Litig.*, 352 F. Supp. 2d 472, 500-01 (S.D.N.Y. 2005).

[28] *See, e.g.*, Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 Conn. L. Rev. 1097, 1101 (Feb. 2007); *Cf.* Richard P. Swanson, *Theories of Liability*, Accountants' Liability, ALI-ABA Course of Study Materials, at n. 135 (July 9-10, 2009) (collecting cases both prior to and after the enactment of the PSLRA in 1995).

[29] 15 U.S.C. §78u-4(b)(2).

[30] *In re Doral Fin'l Corp. Sec. Litig*., 563 F. Supp 2d 461, 464 (S.D.N.Y. 2008) (citation omitted).

[31] *See, e.g.*, *In re Polaroid Corp. Sec. Litig.*, 465 F. Supp. 232, 246 (S.D.N.Y. 2006) (''While [the auditor] might in some way benefit from helping keep [the audit client] afloat, such as by retaining [the client's] business, courts in this Circuit have repeatedly found that such generalized motives, being ubiquitous, are insufficient to establish scienter.''); *In re Health Mgmt., Inc. Sec. Litig*., 970 F. Supp. 192, 202 (E.D.N.Y.1997) (holding that ''receipt of professional fees is not a sufficient motive to plead a 'strong inference' of scienter.''); *Zucker v. Sasaki*, 963 F. Supp. 301, 308 (S.D.N.Y.1997) (holding that ''mere receipt of compensation and the maintenance of a profitable professional business relationship for auditing services does not constitute a sufficient motive for purposes of pleading scienter.'').

[32] *See generally Reiger v. Altris Software*, No. 98-CV-528, 1999 WL 540893, at *3 (S.D. Cal., Apr. 30, 1999) (finding allegations that an auditor would ''perpetuate a fraud on investors are irrational,'' and collecting New York cases); *But see In re Countrwide Sec. Litig.*, 588 F. Supp. 2d at n. 79 (''Some courts have given outside auditors as a class remarkable deference, in part because some courts think outside auditors lack any rational economic incentive to participate in its client's fraud. The Court finds this supposition suspect, at best.'') (internal quotations and citation omitted).

[33] *Rothman v. Gregor*, 220 F.3d 81, 98 (2d Cir. 2000).

[34] *See, e.g.*, *In re Doral Fin'l Corp.*, 563 F. Supp 2d at 466 (holding that plaintiffs' allegations ''may raise an inference that [the auditor] was negligent . . . but it certainly does not show the conscious turning away from the true facts required for recklessness.''); *In re Polaroid*, 465 F. Supp. at 247 (''[T]he Amended Complaint suggests at most that [the auditor] was negligent, and certainly does not allege facts that rise to the level of malfeasance required for plaintiffs to plead recklessness with the requisite particularity.''); *O'Brien v. Price Waterhouse*, 740 F. Supp. 276, 280 (S.D.N.Y. 1990) (''Even if the defendant accounting firm should have made further inquiries to attempt to uncover the alleged fraud, failure to make further inquiries does not rise above the level of negligence, which is legally insufficient.'').

[35] *Zucker*, 963 F. Supp. at 307.

[36] *Tellabs*, 551 U.S. at 313.

[37] *Id.* at 314.

[38] Hoffman et al., *supra* note 21, at 628.

auditors under the Securities Act of 1933 (''Securities Act''). Specifically, Section 11 of the Securities Act provides that investors who purchase securities pursuant to a false or misleading registration statement may pursue a cause of action against the issuer, underwriters, and auditors.[39]

Unlike securities fraud actions under the Exchange Act, Section 11 claims under the Securities Act may be based solely on negligence – scienter is not required.[40] In addition, claims brought under the Securities Act are not subject to the heightened pleading standards of the PSLRA.[41] Thus, plaintiffs will assert Section 11 claims whenever possible, provided they have standing as purchasers or sellers in an offering of securities.[42]

Section 11 provides a ''due diligence'' defense for non-issuer defendants, such as auditors and underwriters.[43] Specifically, auditors can defend against a Section 11 claim by showing that they conducted a ''reasonable investigation'' and had ''reasonable ground to believe and did believe'' that their audit report was true and not materially misleading.[44] In general, ''compliance with GAAS should ordinarily satisfy the [auditor's] due diligence obligation.''[45] However, much like proving compliance with GAAS, proving ''due diligence'' under Section 11 is usually a question of fact that cannot be resolved at the pleadings stage.[46]

Although the PSLRA's scienter pleading standards do not apply to Section 11 claims, a motion to dismiss can still succeed under the right circumstances. For example, when a Section 11 claim is based on allegations of fraudulent conduct, the claim must meet the heightened pleading requirements of Federal Rule of Civil Procedure 9(b).[47] Courts have readily found that Section 11 claims allege fraud when based on the same fraudulent conduct alleged to support Section 10(b) claims in the same complaint.[48]

However, a Section 11 claim may allege fraud—and must meet fraud pleading standards—even if it is not combined with a claim under Section 10(b).[49] For example, ''allegations of knowing and deliberate misrepresentations fundamentally sound in fraud.''[50] Moreover, ''plaintiffs' bald assertion that their Section 11 claims do not sound in fraud are not enough to avoid application of Rule 9(b) where the wording and imputations of the complaint are classically associated with fraud.''[51]

When a Section 11 claim is based on allegations sounding in fraud, the complaint must ''state with particularity the circumstances supporting an allegation of fraud.''[52] Rule 9(b) requires that a complaint ''(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent.''[53] Although not as stringent as the pleading standard of the PSRLA, the application of Rule 9(b) to Section 11 claims sounding in fraud provides similar opportunities for defendants to seek dismissal on the pleadings for failure to plead fraud with sufficient particularity.

Whether a Section 11 claim is based on allegations of negligence or fraud, the complaint must meet certain minimum requirements to withstand a motion to dismiss, as recently clarified by the Supreme Court's *Twombly* decision.[54] Under *Twombly*, a court deciding a motion to dismiss must consider whether the complaint ''state[s] a claim to relief that is plausible on its face.''[55] This plausibility standard requires that ''[f] actual allegations must be enough to raise a right to relief above the speculative level.''[56]

Section 10(b) claims must also meet the *Twombly* standard. As one court recently noted, ''[i]f plaintiffs 'have not nudged their claims across the line from conceivable to plausible, their complaint must be dismissed.' ''[57] Accordingly, for any claims brought under the federal securities laws, auditor defendants are well-advised to seek dismissal on the pleadings for failure to meet the *Twombly* standard, which ''prohibits precisely the kind of conclusory pleadings that appear so often in claims against [auditors].[58]

C. State Securities Laws

Although individual investors can bring securities claims under state ''blue sky'' laws, such claims are becoming increasingly difficult to assert.[59] Private class

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[39] 15 U.S.C. §77k(a).

[40] *Rombach v. Chang*, 335 F.3d 164, 171 (2d Cir. 2004) (''[P] laintiff need allege no more than negligence to proceed under Section 11''); *In re WorldCom*, 352 F. Supp. 2d at 494 (''Plaintiff has no burden to show that [the auditor] acted with scienter in violating Section 11.'').

[41] *Ladmen Partners, Inc. v. Globalstar, Inc*., No. 07 Civ. 0976, 2008 U.S. Dist. LEXIS 76670, at *31 n.9 (S.D.N.Y. Sept. 30, 2008) (''The PSLRA . . . applies only to claims brought under the Exchange Act.''). However, other provisions of the PSLRA are applicable to Securities Act claims, including the stay of discovery. 15 U.S.C. §§77z-1 and 77z-2 *et. seq*., §77z-1(b)(1).

[42] Maureen Aidasani and Kenneth Cunningham, *Overview of Key Defenses Available in a Section 11 Claim against an Auditor*, Accountants' Liability, ALI-ABA Course of Study Materials, at 211, 213 (July 9-10, 2009); Swanson, *supra* note 28, at 56 (''[P]laintiffs try very hard to fit their claims under the 1933 Act wherever possible, particularly since not only is there no scienter requirement . . . the heightened fraud pleading standards of the PSLRA do not apply[.]''); Talley, *supra* note 6, at 1657 (referring to Section 11 claims as ''infrequently used, but highly effective in the right circumstances'').

[43] Aidasani et al., *supra* note 42, at 223.

[44] 15 U.S.C. §77k(b)(3)(B)

[45] *In re WorldCom*, 352 F. Supp. 2d at 492.

[46] *In re Countrywide*, 588 F. Supp. 2d at 1175 (denying motion to dismiss Section 11 claims based on a due diligence defense, because ''[r]easonableness is generally a fact issue, rarely suitable for summary judgment, let alone a motion to dismiss.'').

[47] *Rombach,* 335 F.3d at 171; *Ladmen*, 2008 U.S. Dist. LEXIS 76670, at *31.

[48] *Rombach,* 335 F.3d at 171.

[49] *Ladmen*, 2008 U.S. Dist. LEXIS 76670, at *32.

[50] *Id*. at *38.

[51] *Id.* at *35 (internal quotations and citations omitted).

[52] *Id.* at *30-31.

[53] *Id.* at *31.

[54] *See Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007).

[55] id., at 570.

[56] *Ladmen*, 2008 U.S. Dist. LEXIS 76670, at *28 (quoting *Twombly*, 550 U.S. at 555).

[57] *Kirschner v. Grant Thornton, LLP*, No. 07 Civ. 11604, 2009 WL 996417, at *5 (S.D.N.Y. Apr. 14, 2009) (quoting *Twombly* 550 U.S. at 570).

[58] Aidasani et al., *supra* note 42, at 215.

[59] For additional claims that investors may bring against auditors under state law that are distinct from state securities

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actions under state securities laws are preempted by federal law under the Securities Litigation Uniform Standards Act of 1998 (''SLUSA'').[60] In addition, many state law securities claims can now be removed to federal court under the Class Action Fairness Act (''CAFA'').[61]

The intricacies of each state's securities laws is beyond the scope of this article. However, whether investor claims are brought under federal or state law, if they allege fraud, then the auditor must explore moving to dismiss the case for failure to plead the elements of fraud—particularly scienter—with sufficient particularity. Whether that motion is granted will, of course, depend on the specific allegations of the complaint.

III. Defending Against Malpractice Claims

Securities suits by aggrieved investors are not the only source of litigation against auditors in the wake of a market crisis. Auditor malpractice suits by the audit client (or by someone standing in the shoes of the audit client) also typically follow. The current financial crisis has already spawned several such cases, with damages alleged to be in the billions of dollars.[62]

A. Elements of an Auditor Malpractice Claim

Auditor malpractice usually refers to any claim alleging professional negligence, or breach of the auditor's duty of care as defined by professional standards.[63] Unlike securities fraud, auditor malpractice claims must be brought under state law, as there is no auditor malpractice claim under federal law. Moreover, because auditor malpractice claims are based on negligence, they are not subject to the heightened pleading standards applied to fraud claims.[64] For example, a claim for auditor malpractice under New York law requires ''that there was a departure from accepted standards of practice and that the departure was a proximate cause of the injury.''[65]

The auditor's duty of care is generally defined by GAAS.[66] An auditor can defend against a malpractice claim by showing that the audit was conducted in accordance with GAAS and thus there was no breach of the duty of care.[67] However, determining whether an auditor breached the duty of care is typically a fact-based inquiry that requires expert testimony.[68] Thus, it is difficult to obtain dismissal of malpractice claim by asserting a reasonable care defense based on the pleadings. There are nonetheless several other effective defenses that can be effectively asserted at the pleading stage.

B. Standing and Privity

Investors and other third parties lack privity with the auditor and therefore do not have standing to bring a malpractice claim.[69] Subject to very limited and rarely applicable exceptions, it is well-settled that only the audit client can sue the auditor for malpractice.[70] New York courts in particular have consistently dismissed third party malpractice claims against auditors for lack of privity, even as other jurisdictions have relaxed the privity standard and adopted a less stringent ''foreseeability'' approach.[71]

The audit client, however, is usually not inclined to sue its auditor. An audit client that pursues a claim against its auditor must appoint a new auditor, as the original auditor's independence is impaired once it is in an adversarial position to its audit client.[72] Changing auditors can be burdensome under normal circum-

fraud claims, *i.e.*, common law fraud, see Goldwasser, *supra* note 10, at §5:1.1(B).

[60] *See, e.g.*, Andrew B. Kratenstein, *Controlling Opt Outs and Coordinated Cases: SLUSA, The All Writs Act, and CAFA*, Managing Complex Litigation 2008: Legal Strategies and Best Practices 786 PLI/Lit 155, 159-60 (Nov. 11, 2008).

[61] *Id. at* 173.

[62] See *In re The New Century Liquidating Trust v. KPMG LLP*, No. BC410846 (Cal. Apr. 1, 2009).

[63] *See, e.g., Am. Tissue, Inc., v. Arthur Andersen, LLP*, 275 F. Supp. 2d 398, 405 n.7 (S.D.N.Y. 2003) (''Although [the plaintiff] brings claims for malpractice, breach of contract and breach of fiduciary duty, these three causes of action boil down to one claim for the provision of deficient accounting services.'') *In re Wedtech Corp. (Wedtech Corp. v. KMG Main Hurdman)*, 81 B.R. 240, 241 (S.D.N.Y. 1987) (holding that various allegations ''although brought under many different theories, all sound in malpractice'').

[64] *Rombach*, 335 F.3d at 178 (''These claims are not subject to the heightened pleading requirements of Rule 9(b), because they sound in negligence.''); *See also* Goldwasser, *supra* note 9, §4:2 (''The pleading of a professional malpractice claim is generally governed by Rule 8 of the Federal Rules of Civil procedure or its state law counterpart, rather than by Rule 9(b).'')

[65] *Frank v. Frank*, No. 97 Civ. 5380, 2000 U.S. Dist. LEXIS 5152, at *15 (S.D.N.Y. Apr. 17, 2000). New York courts do not recognize a separate claim for auditor malpractice under contract law. *Seghers v. Deloitte & Touche USA LLP*, No. 602135/06, 2007 N.Y. Misc. LEXIS 6598, at *19 (S.D.N.Y. Aug. 13, 2007) (holding that a breach of contract claim premised on the failure to ''abide by general professional standards is nothing but a redundant pleading of [a] malpractice claim.'').

[66] *Cumis*, 293 A.D.2d at 797-98 (''a failure to exercise due care and proof of a material deviation from the recognized and accepted professional standards for accountants and auditors, generally measured by GAAP and GAAS promulgated by the American Institute of Certified Public Accountants, which proximately causes damage to plaintiff.'').

[67] *Estate of Burke v. Peter J. Repetti & Co.*, 255 A.D.2d 483, 483 (2d Dep't 1998) (affirming the district court's grant of summary judgment in favor of the defendants because ''[t]he plaintiff failed to come forward with evidence that the defendants' actions deviated from accepted accounting practice.'').

[68] Goldwasser, *supra* note 9, §4:2.3

[69] *Ultramares Corp. v. Touche*, 255 N.Y. 170, 189 (1931) (''[L]iability for negligence is . . . bounded by the contract, and is to be enforced between the parties by whom the contract has been made.''); *Stenger v. Ernst & Young LLP*, 861 N.Y.S. 2d 578, 587 (Sup. Ct. N.Y. Co. 2008) (holding that the auditor's client ''is the only party that is permitted to recover against [the auditor] for its alleged negligence stemming from the audit, and not the [audit client's] investors.'')

[70] *Stenger*, 861 N.Y.S. 2d 586 (''[It is] a well-settled principle that a negligence claim against a corporate accountant belongs to the corporation-client, unless there is privity between the accountant and the non-client claiming harm.''). For a detailed review of the privity requirement and its exceptions, see Jay M. Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 Fla. St. U. L. Rev. 17 (Fall 2003).

[71] *Credit Alliance v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 553 n.11 (1985). For a detailed review of the history and criticisms of *Ultramares*, see Swanson, *supra* note 28, at 25-43.

[72] Financial Reporting Codification, Section 600, Matters Relating to Independent Accountants, reprinted in SEC Accounting Rules (CCH) ¶ 3,851 at 3,781.

stances, let alone when the audit client is dealing with a restatement, significant write-downs or a high-profile investigation, all of which often coincide with investor lawsuits. Under such adverse conditions, the audit client usually benefits from continuity and cooperation from its auditor.

Further, companies must be wary of implicating their former auditor in significant high-stakes litigation as the auditors' defense strategy may strengthen other parties' claims. For example, an auditor faced with securities fraud claims may allege that the audit client's executive officers and directors orchestrated the alleged fraudulent scheme and concealed it from the auditor.[73]

Although a solvent audit client will understandably be hesitant to sue its auditor, a bankrupt audit client has very different incentives.[74] Under the Bankruptcy Code, a trustee ''has standing to bring any suit that the bankrupt corporation could have brought had the corporation not filed for bankruptcy.''[75] When a corporation emerges from bankruptcy, these claims are sometimes assigned to a litigation trust, which pursues the claims for the benefit of creditors.[76]

These bankruptcy devices allow third parties to circumvent the privity requirement and obtain standing to sue the debtor corporation's auditors for malpractice.[77] Often, the debtor's claims against auditors and other professional advisors are the estate's primary unencumbered assets.[78] Not surprisingly then, auditor malpractice claims are primarily brought by a successor-in-interest to the audit client, such as a bankruptcy trustee or litigation trust.[79]

C. *In Pari Delicto* and the *Wagoner* Rule

When the audit client or a trustee sues the auditor for malpractice, the auditor should assess whether it can make a motion to dismiss the case under the doctrine of *in pari delicto* or the *Wagoner* rule. *In pari delicto*, which literally means ''in equal fault,'' is based on the equitable principle that ''a participant in a fraud cannot also be a victim entitled to recover damages.''[80] Thus, an audit client that commits fraud cannot seek redress for the auditors' alleged participation in the same fraud. The *in pari delicto* defense ''is grounded on two premises: first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality.''[81]

In the bankruptcy context, a similar concept is applied under the so-called *Wagoner* rule, which ''deprives a bankruptcy trustee of standing to assert a claim against a third party for wrongdoing to the corporation with the cooperation of management.''[82] The *Wagoner* rule is based on the premise that the bankruptcy trustee ''has standing to bring any suit that the bankrupt corporation could have brought had the corporation not filed a petition for bankruptcy.''[83] Thus, if the debtor corporation did not have a valid claim against its auditors prior to bankruptcy, then the bankruptcy trustee is also precluded from bringing such a claim.

The *in pari delicto* defense is based on ''the usual presumption that the acts and knowledge of an agent acting within the scope of employment are imputed to the principal.''[84] Thus, the fraudulent acts and knowledge of the audit client's managers are imputed to the audit client itself. Without imputation, the audit client is not deemed a participant in the fraud of its managers, and the *in pari delicto* defense does not apply.

Both *in pari delicto* and the *Wagoner* rule have been successfully invoked to dismiss malpractice claims at the pleading stage.[85] For example, courts have held that dismissal is appropriate when the plaintiff alleges that the company's insolvency was caused by auditor negligence, and concurrently alleges fraudulent and reckless conduct by the company's managers.[86] Thus, dismissal is appropriate when the complaint (including documents incorporated by reference in the complaint or public filings of which judicial notice can be taken) indicates that management is at least as culpable as the auditor for the company's financial distress.[87]

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[73] *See generally In re Doral Fin'l Corp.*, 563 F. Supp 2d at 467 (finding that auditor was more likely a victim of the audit client's fraud than a participant); *In re WorldCom,* 352 F. Supp. 2d at 495 (''When records of a company's financial impropriety are hidden from its auditor, an auditor is not held responsible simply because the auditor lent its imprimatur to the company's financial statement.'').

[74] *See Maxwell v. KPMG, LLP*, 520 F.3d 713, 718 (7th Cir. 2008) (''The filing of lawsuits by a going concern is properly limited by concern for future relations with suppliers, customers, creditors, and other persons with whom the firm deals . . . and by the cost of litigation. The trustee of a defunct enterprise does not have the same inhibitions.'') (dismissing claims against auditors and awarding costs).

[75] *In re Bennett Funding Group, Inc.*, 336 F. 3d 822, 826 (2d Cir. 2003); 11 U.S.C. §541.

[76] *See generally* Michael J. Venditto, *Litigation Trusts*, N.Y.L.J. (Sept. 8, 2008).

[77] *Id*.

[78] Andrew Z. Schwartz and Euripides Dalmanieras, *Developments in the* In Pari Delicto *Doctrine in Massachusetts*, Boston Bar Journal at 16 (Sept./Oct. 2008) (noting that claims against professional advisors, including auditors, ''are often the estate's primary unencumbered assets, and may be the sole means of funding a dividend to unsecured creditors.'').

[79] Swanson, *supra* note 28, at 43 (''While . . . it would appear to be somewhat unusual for a client to sue his own [auditor], this kind of litigation actually arises with frequency, as bankruptcy trustees, receivers, or other persons who step into the shoes of the client . . . become aggressive about asserting claims.'')

[80] *Baena v. KPMG LLP*, 453 F.3d 1, 6 (1st Cir. 2006); *Cenco Inc. v. Siedman & Seidman*, 686 F.2d 449, 454 (7th Cir. 1982).

[81] *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985).

[82] *Stenger*, 861 N.Y.S. 2d at 581 (citing *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 120 (2d Cir. 1991)).

[83] *Kirschner,* 2009 WL 996417, at *5 n.12.

[84] *In re The Mediators, Inc.,* 105 F.3d 822, 827 (2d Cir. 1997).

[85] *See, e.g., Kirschner,* 2009 WL 996417, at *1 (granting motion to dismiss with prejudice); *Am. Tissue, Inc. v. Arthur Andersen,* LLP, 2003 U.S. Dist. LEXIS 22137, No. 02 Civ. 7751, (S.D.N.Y. Dec. 3, 2003) (granting motion to dismiss with prejudice). *But see, NCP Litig. Trust v. KPMG LLP*, 901 A. 2d 871, 878 (N.J. Sup. Ct. 2006) (''[D]eciding whether to permit an auditor to utilize imputation requires a detailed factual analysis of the dispute. Consequently, many courts have held that the applicability of the imputation defense to a particular case cannot be determined on a motion to dismiss or on a motion for summary judgment.'') (internal quotations and citations omitted).

[86] *Am. Tissue*, 275 F. Supp. 2d at 404; *Kirschner*, 2009 WL 996417, at *5.

[87] *Am. Tissue*, 275 F. Supp. 2d at 405 (dismissing malpractice claim against auditors ''in light of [plaintiff's] own binding

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1. Adverse Interest Exception

Although imputation is generally presumed under well-established principles of agency law, there are exceptions to the rule. The adverse interest exception prevents imputation of an agent's conduct to the corporation when the agent acts ''entirely in his own interest and adversely to the interests of the corporation.''[88] This exception ''is a narrow one and applies only when the agent has *totally abandoned* the principal's interests.''[89] Even where the agent's conduct eventually harms the corporation, ''the relevant issue is short term benefit or detriment to the corporation, not any detriment to the corporation from the unmasking of the fraud.''[90]

Most courts to address the issue have rejected adverse interest arguments, even where the benefits to the corporation are short lived or cancelled out by the eventual harms after the fraud is discovered.[91] Rather, the adverse interest exception has been applied only in extreme cases involving corporate looting, embezzlement or similar self-serving actions that fail to create any benefit whatsoever for the corporation.[92]

Although it is an extremely limited exception to imputation, plaintiffs have successfully raised the adverse interest exception to creating an issue of fact as to whether fraud committed by members of corporate management was for the benefit of, or adverse to, the corporation.[93] For example, in *In re CBI Holding Co., Inc. v Ernst & Young*, the trustee brought malpractice claims against the former auditors for failure to detect financial reporting fraud perpetrated by CBI's employees and managers.[94] After a bench trial, the bankruptcy court determined that the agents' fraudulent conduct should not be imputed to the corporation under the adverse interest exception.[95] The court's determination was based, in part, on an employee's testimony that the intended purpose of the fraud was to maximize bonus compensation for the president and chairman.[96]

Based on this testimony, the bankruptcy court held that CBI's agents intended to benefit themselves or a third party, not the company, and therefore the fraudulent conduct of CBI's managers and employees should not be imputed to the company itself.[97] This emphasis on intent arguably requires a more fact-based review, which could prevent courts from accepting the *in pari delicto* defense on the pleadings. The Second Circuit, applying a deferential standard of review, declined to disturb the bankruptcy court's findings of fact.[98]

The viability of the *in pari delicto* defense at the pleading stage was reinvigorated, however, in the recent *Kirschner* case.[99] In *Kirschner*, a corporation's managers allegedly concealed billions of dollars of debt using complex related party transactions, causing the company to declare bankruptcy within weeks of its initial public offering.[100] As part of its bankruptcy plan, the company's claims were assigned to a litigation trust, which brought malpractice claims against the former auditors and other professional services firms. The trustee argued that the adverse interest exception applied because the insiders intended only to benefit themselves and not the company.[101]

Citing *CBI*, the trustee also argued that the adverse interest exception was based on an inherently fact-specific ''intent based'' standard, and therefore imputation could not be decided at the pleading stage.[102] The court rejected the trustee's arguments, holding that the adverse interest exception did not apply because ''the gravamen of the Trustee's allegations is not that the insiders stole assets *from* [the company], but rather that the insiders' fraudulent scheme was to steal *for* [the company].''[103] Stated differently, ''the trustee must allege, not that the insiders intended to, or to some extent did, benefit from their scheme, but that the corporation was *harmed* by the scheme, rather than being one of its beneficiaries.''[104]

The court in *Kirschner* also emphasized that imputation may be decided at the pleadings stage.[105] In *CBI*, the Second Circuit reviewed a lower court's findings of fact under a ''clearly erroneous'' standard.[106] By contrast, the issue in *Kirschner* was ''whether the trustee has pleaded facts that show that the insiders acted adversely to – or totally abandoned – the corporation's interest.''[107] The allegations in the complaint demonstrated that the insiders were not acting adversely to the corporation, but rather that the corporation had ben-

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admissions'' in separate complaint filed against managers for breach of fiduciary duty and unjust enrichment).

[88] *Wight v. Bank Am. Corp.*, 219 F.3d 79, 87 (2d Cir. 2000).

[89] *In re The Mediators, Inc.*, 105 F.3d at 827 (emphasis added).

[90] *Kirschner,* 2009 WL 996417, at *6 (internal quotations and citation omitted).

[91] *See, e.g., Baena v. KPMG LLP*, 453 F.3d at 16 (1st Cir. 2006) (''A fraud by top management to overstate earnings, and to facilitate stock sales or acquisitions, is not in the long-term interest of the company; but, like price-fixing, it profits the company in the first instance and the company is still civilly and criminally liable.''); *Cobalt Multifamily Inv., LLC v. Shapiro*, No. 06 Civ. 6468, 2008 WL 833237, at *4 n.10 (S.D.N.Y. Mar. 28, 2008) (holding that as a matter of New York law ''where a corporation benefits to *any* extent from the fraudulent acts of its agents, the agents cannot be said to have 'totally abandoned' the interests of the corporation'').

[92] *See, e.g., Wight,* 219 F.3d at 87 (looting, misappropriation of bank assets).

[93] *See, e.g., Capital Wireless Corp. v. Deloitte & Touche*, 627 N.Y.S.2d 794, 797 (3d Dep't 1995) (''In this preanswer, prediscovery stage of the action, we find that resolution of this [adverse interest] issue is more appropriately left for trial.''); *Williamson v. PricewaterhouseCoopers*, LLP, No. 602106/04, 2007 WL 5527944, at *7 (Sup. Ct. N.Y. Co., Nov. 7, 2007) (denying motion for summary judgment because ''there is an issue of fact about whether [the culpable manager] totally abandoned the interests of the [company] that only a jury can determine.''); *In re Wedtech Sec. Litig.*, 138 B.R. 5, 9) (S.D.N.Y.1992). (''We find that the complex factual background as well as the central credibility issues [regarding the adverse interest exception] do not make this case capable of resolution on a summary judgment motion.'').

[94] *In re CBI Holding Co., Inc. v Ernst & Young LLP*, 529 F.3d 432, 451 (2d Cir. 2008).

[95] *In re CBI Holding Co., Inc. v Ernst & Young LLP*, 247 B.R. 341, 365 (Bankr. S.D.N.Y. 2000).

[96] *In re CBI Holding*, 529 F.3d at 443 (2d Cir. 2008).

[97] *Id.*

[98] *Id.* at 453.

[99] *Kirschner*, 2009 WL 996417, at *7-8.

[100] *Id.* at *3.

[101] *Id.* at *7.

[102] *Id.*

[103] *Id.*

[104] *Id.*

[105] *Id.*

[106] *In re CBI Holding*, 529 F.3d at 449.

[107] *Kirschner,* 2009 WL 996417, at *7.

efited because the fraudulent misconduct had ''enabled the false reporting of the company's steady growth, which in turn, attracted and retained capital from investors.''[108] Although the trustee also alleged that the manager's fraud benefited themselves and other third parties, these allegations did not indicate any harm to the company and were therefore insufficient to trigger the adverse interest exception, and the case was dismissed.[109] Accordingly, *Kirschner* is a potentially powerful precedent for auditors seeking dismissal of malpractice claims.

2. Sole Shareholder Rule

Even when the adverse interest exception is found to apply, that is not the end of the inquiry. The so-called ''sole shareholder rule'' may provide an alternate basis for imputation.[110] When an agent is the sole shareholder of the corporation, the agent's conduct will be imputed to the corporation, regardless of whether the corporation was harmed or benefited as a result.[111] ''The reasoning behind the rule is, where the principal and the agent are one and the same, it makes no sense not to impute the agent's acts of fraud to the corporation even if there was a total abandonment of the corporation's interests.''[112]

For example, in *In re The Mediators*, the president and sole shareholder of a corporation hired an accounting firm and a law firm to transfer expensive artwork from the corporation to his own name, in order to protect the art collection from creditors.[113] Three years later, the corporation entered bankruptcy.[114] Plaintiffs, a committee of unsecured creditors, brought claims against the accounting firm and the law firm for their participation in the artwork transaction, arguing that ''under the adverse interest exception, [the president's] actions cannot be imputed to [the company] because the art transfer was detrimental to the corporation's interests.''[115]

Affirming the lower court's dismissal, the Second Circuit held that ''the adverse interest exception does not apply to cases in which the principal is a corporation and the agent is its sole shareholder.'' If the agent committing fraud is the ''sole shareholder and decision maker, [then] whatever decisions he made were, by definition, authorized by, and made on behalf of, the corporation.''[116] Thus, under the right factual circumstances, the sole shareholder rule can preclude application of the adverse interest exception.

D. Successors-in-Interest

Although reliant on agency principles, the doctrine of *in pari delicto* remains an equitable defense, and some courts have declined to apply *in pari delicto* on equitable grounds.[117] In such cases, courts reason that claims brought by a successor-in-interest—such as a bankruptcy trustee, receiver, or litigation trust—should not be dismissed because the wrongdoer has been removed from the company and any recoveries would flow to the aggrieved creditors, who may otherwise lack standing to assert a direct claim.[118]

In New York, at least one court has declined to apply *in pari detective* based on the innocent successor rule. In *Williamson*, the liquidating trustee of a hedge fund brought a malpractice claim against the fund's former auditors, who had allegedly failed to detect errors in the valuation models used by a hedge fund that collapsed.[119] The court held ''it would be inequitable to apply *in pari delicto* to block the [liquidating] trustee's claims,'' because ''[the auditor], an alleged wrongdoer, would enjoy complete protection while the innocent investors might fail to receive redress.''[120] The court emphasized that any recoveries would be for the benefit of ''innocent investors'' who could not directly sue the auditor.[121]

That holding, however, has been called into question.[122] In *Stenger*, a liquidating trustee argued that *in pari delicto* did not bar its claims against the auditor, citing *Williamson*.[123] The court unequivocally rejected this argument, stating, ''The court respectfully disagrees that there is an 'innocent successor' exception to the *Wagoner* rule and imputation.''[124]

The court reasoned that the innocent successor rule is contrary to two well-established principles of law. First, adopting the innocent successor rule ''would fly in the face of the well-established agency principle that the knowledge and conduct of an agent acting within the scope of employment are imputable to the principal.''[125] Second, applying the innocent successor rule ''for the benefit of the Fund's investors would be inconsistent with the well-settled principle that a negligence claim against a corporate accountant belongs to the corporation-client, unless there is privity between the accountant and the non-client claiming harm.''[126]

Indeed, the innocent successor rule has not prevented courts from applying the *Wagoner* rule to all forms of successors-in-interest, including not just bankruptcy trustees,[127] but also liquidating trustees,[128] liti-

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[108] *Id.* at *6.
[109] *Id.*
[110] *In re The Mediators*, 105 F. 3d at 827
[111] *Id.*
[112] *Williamson*, 2007 WL 5527944, at *7.
[113] *In re The Mediators*, 105 F. 3d at 824.
[114] *Id.*
[115] *Id.* at 827.
[116] *Id.*
[117] *See, e.g., In re Adelphia Commc'n Corp.*, 365 B.R. 24, 48-49 (Bankr. S.D.N.Y. 2007) (application of *in pari delicto* ''involves discretionary attention to the fairness of applying to the facts in a given case.''); Amelia Toy Rudolph and Drew D. Dropkin, *Invoking* In Pari Delicto *To Bar Accountant Liability Actions Brought By Trustees and Receivers*, Accountants' Liability, ALI-ABA Course of Study Materials 329, 335 (July 9-10, 2009) (''Some jurisdictions disallow the *in pari delicto* defense when its invocation would produce an inequitable result.'') (listing cases).
[118] *See Williamson*, 2007 WL 5527944, at *4 (''[W]here a recovery could benefit the innocent investors only and where otherwise a potentially responsible party could escape liability, the court declines to apply *in pari delicto*.'').
[119] *Id.* at *5.
[120] *Id.*
[121] *Id.* at *6.
[122] *Stenger*, 861 N.Y.S. 2d at 586.
[123] *Id.*
[124] *Id.*
[125] *Id.*
[126] *Id.*
[127] *Brown v. Deloitte & Touche, LLP*, No. 98 Civ. 6054, 1999 U.S. Dist. LEXIS 6279, at *7 (S.D.N.Y. May 3, 1999) (''Were the trustee to proceed on behalf of a creditors' committee. . . he would still be precluded from filing this suit by virtue of the *Wagoner* rule.'').

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gation trusts,[129] and creditors' committees.[130] Auditors facing malpractice actions from successors-in-interest should nonetheless be aware of this potential exception to the *in pari delicto* defense and the *Wagoner* rule.

IV. Conclusion

As the fall out from the economic crisis widens, litigation against auditors and other professional advisors is likely to increase. It is important for auditors and their counsel to re-familiarize themselves with the arsenal of arguments at their disposal when a client's investors, a client's creditors, or the client itself sue the auditor. Fraud-based claims can be defeated on the pleadings if the plaintiff fails to plead the elements of their claim – particularly scienter – with the requisite specificity. Although negligence-based claims, such as auditor malpractice, may be more difficult to defeat prediscovery, where the audit client has engaged in a wide-ranging fraudulent scheme, the auditor should assert that the malpractice claim is barred by the doctrine of *in pari delicto* or the *Wagoner* rule. As the growing number of lawsuits against auditors proceed through the courts, application of these doctrines will undoubtedly evolve. Auditors and their counsel would do well to monitor these developments closely in order to effectively gauge the impact on their own litigation exposure.

☐ *For related portfolio discussion, see Accounting Policy & Practice Portfolio 5500, Preparing for and Defending Accounting Liability Litigation, and Portfolio 5501, The Liability of Accountants to Non-Clients for Professional Malpractice.*

[128] *Stenger*, 861 N.Y.S. 2d at 587.
[129] *Kirschner*, 2009 WL996417, at *6.
[130] *In re The Mediators*, 105 F.3d at 827.