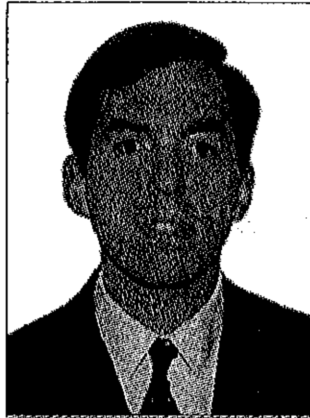
New York Law Journal

Wednesday, November 26, 2003

OUTSIDE COUNSEL

BY TERENCE W. McCORMICK

'Red Flag' Claims Against Auditors in the Post-Enron World



Five years after the passage of the Private Securities Litigation Reform Act of 1995 (PSLRA), but well before the current high-profile securities class actions were filed, the litigation costs borne by the "Big Five" accounting firms had defied predictions and were already back on the rise. In the last three years, the costs of settling such lawsuits have risen yet again.

The inevitable question becomes whether, possibly as the result of judicial skepticism of the role of auditors in recent accounting scandals, plaintiffs have quietly been granted more liberal treatment under the PSLRA's pleading requirements. This article discusses recent decisions that have examined the conduct of auditors, with a particular focus on the auditors' response to "red flags" under generally accepted auditing standards (GAAS).

10b-5 Litigation

In the PSLRA, Congress responded to the proliferation of abusive "strike" suits with sweeping reforms, including strict pleading requirements. Thus, the PSLRA requires in a 10b-5 action that the plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." In the Second Circuit, a plaintiff must either allege facts showing that "defendants had both motive and opportunity to commit fraud" or state facts that "constitute strong circumstantial evidence of conscious misbehavior or recklessness."[1]

Claims that the outside auditor possessed scienter under 10b-5 are usually sustained under a recklessness standard, rather than motive and opportunity. The most fertile ground for claims of recklessness is that in the course of the audit the auditor disregarded its obligations under GAAS, such that the audit was, in effect, "no audit at all or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments ... were such that no reasonable accountant would have made the same decision if confronted with the same facts."[2]

Generally accepted accounting principles and GAAS have long been accorded the force of law by the Securities and Exchange Commission as the minimum standards applicable to financial reporting for public companies. SEC regulations generally provide that publicly filed financial statements must conform to GAAP and, if an issuer presents non-GAAP information in a public filing, new Regulation G now requires that the issuer also disclose reconciling adjustments to GAAP in the same filing. In fact, SEC regulations establish a presumption that non-GAAP information is misleading or inaccurate, despite footnotes or other disclosure, unless the SEC has provided otherwise.[3]

In the realm of 10b-5 litigation, courts treat compliance with GAAP or GAAS as the principal measure of the auditor's duty of care; however, it is not the final word. For example, the Second Circuit held in *Chill v. General Electric Company*[4] that "allegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent, are not sufficient to state a securities fraud claim." Conversely, compliance with GAAP or GAAS is not a complete defense if scienter is otherwise provable.[5]

The Duty of Skepticism

Underlying any allegation that the auditor was reckless in failing to comply with GAAS is the notion that the first duty of the auditor is to detect fraud. This notion is something of an exaggeration, but perhaps not as much of an exaggeration as it once was.

Under SAS 99 the audit team must proactively "brainstorm" how the company's financial statements might be susceptible to fraud, with a particular focus on transactions having a high risk of manipulation by management.

Prior to the PSLRA, under Statement of Auditing Standards (SAS) 53 and 54, auditors were required to conduct audits with a degree of professional skepticism, bearing in mind the possibility of fraud, but were not otherwise responsible for identifying illegal acts as such, under the theory that it is possible to defraud auditors.

However, in 1997 SAS 53 was superceded by SAS 82, which required that in planning and carrying out audit procedures auditors proactively assess the risk of material misstatements due to fraud. In October 2002, the Auditing Standards Board adopted SAS 99, superceding SAS 82. Although continuing to recognize that "management and employees engaged in a fraud will take steps to conceal the fraud from auditors," SAS 99 restated the duty of professional skepticism and further enhanced the auditor's duties under GAAS.

Under SAS 99 the audit team must proactively "brainstorm" how the company's financial statements might be susceptible to fraud, with a particular focus on transactions having a high risk of manipulation by management, as well as transactions involving related parties and special purpose entities (SPEs) such as the off-balance sheet partnerships in the Enron fraud. Accordingly, as the cases discussed below suggest, the issue of an auditor's recklessness may now be resolved

Continued from page 4

quite differently from the way it would have been resolved before.

Red Flags in Recent Cases

Probably the best example of a properly pled complaint grounded on the failure to follow GAAS is the notorious Enron case.

U.S. District Judge Melinda Harmon denied Arthur Andersen's motion to dismiss *In re Enron Corp. Securities, Derivative & Erisa Litigation*,[6] examining in detail numerous violations of SAS 82, which was in effect at the time of the fraud. The complaint not only alleged that the red flags of financial statement fraud were present, but clearly identified facts that showed Arthur Andersen was aware of those red flags and willfully ignored them.

For example, SAS 82 set forth risk factors under GAAS that would trigger an enhanced attention to the possibility of fraud, including overly complex organizational structures involving unusual legal entities (such as the SPEs used by Enron's chief financial officer), significant related-party transactions not in the ordinary course of business, and significant bank accounts or operations in tax haven jurisdictions for which there appears to be no clear business justification.

The complaint identified with ample particularity how, when and why Arthur Andersen knew these red flags were present; indeed, Arthur Andersen had helped structure hundreds of these SPEs for Enron. Nor did it hurt that the plaintiffs were able to identify e-mails within Arthur Andersen expressing alarm at a series of suspect transactions.

Similarly, the Southern District found in *In re Livent, Inc. Securities Litigation*[7] that allegations of recklessness in the audit were sufficient to support scienter. In *Livent*, the plaintiffs not only identified the red flags under GAAS that Deloitte & Touche had encountered, principally regarding occasions of improper revenue recognition, but identified other facts that suggested Deloitte knew, or should have known, that the financial statements were being manipulated. For example, when Deloitte asked for documentation to support Livent's treatment of its expenses, Livent provided only documents for transactions that could be substantiated, but ignored Deloitte's requests regarding the bogus transactions until Deloitte "simply stopped asking."

However, in other cases, plaintiffs have sought to subject auditors to 10b-5 liability based upon nothing more than conclusory allegations that the auditor failed to comply with GAAS. For example, in *DSAM Global Value Fund v. Altris Software, Inc.*,[8] the U.S. Court of Appeals for the Ninth Circuit affirmed the dismissal of a complaint alleging that Price Waterhouse had "egregiously failed to see the obvious" when, in the course of its audit of Altris Software, Inc., it encountered a series of transactions for which Altris had prematurely recognized $4.9 million in revenue. The court agreed with Price Waterhouse that, although it had access to the issuer's documents, access alone did not shed light on the mental state of the auditor.

In *In re Stone & Webster, Inc. Securities Litigation*,[9] the court granted PricewaterhouseCoopers' (PwC) motion to dismiss claims arising from a fraud in which the chief executive officer and the chief financial officer had purportedly failed to book known losses and had booked phantom revenues in connection with underbid construction contracts. The plaintiffs sought to recover against PwC on the basis of a series of red flags that it had encountered in the audit, alleging at one point that PwC failed to take any of the steps set forth in the AICPA audit guide. The court made short work of these allegations, noting in particular:

> The assertion that PwC's auditors "were regularly present at S & W's corporate headquarters throughout the year and had continual access to and knowledge of S & W's private and confidential corporate financial and business information" is not enough to establish scienter. When faced with a nearly identical recital in a securities fraud complaint, another court wrote that "[t]his statement could be made in relation to the auditor of every corporation. If it were sufficient to plead scienter, it might make every auditor liable in cases of securities fraud.[10]

If auditors are the "gatekeepers" of financial reporting, the temptation to punish them simply for failing to outfox dishonest clients must still be resisted.

Other recent claims against auditors have managed to survive motions to dismiss.

For example, in a recent decision in the U.S. District Court for the Southern District of New York, *In re Worldcom, Inc. Securities Litigation*,[11] the court sustained claims against Arthur Andersen amounting to little more than conclusory allegations of a negligent audit.

In *Worldcom*, Andersen "failed to recognize the warning signs" of a two-tiered fraud. According to the complaint, WorldCom improperly capitalized the costs of maintaining telecommunications leases ("line costs") rather than expensing them, thereby inflating earnings in 2001 and the first quarter of 2002 by $3.8 billion. WorldCom also improperly accrued $3.3 billion of phony reserves, often referred to as "cookie-jar reserves," for use in later accounting periods when it needed to boost earnings and meet Wall Street's expectations.

The *WorldCom* court recognized that a violation of GAAP, standing alone, is insufficient to sustain a complaint. However, the court grounded its denial of Andersen's motion to dismiss upon the statement that "Andersen had unlimited access to WorldCom's books and records," and the failure of Andersen properly to examine such books and records under circumstances where, if it had done so, it might have discovered the fraudulent accounting treatment. As seen above, this is precisely the unadorned recitation of negligence that had defeated many other claims against auditors, including Andersen.

Moreover, although it recognized along with many courts before it that the "size of the fraud alone does not create an inference of scienter," the court relied heavily on the nearly biblical size of the fraud to sustain the complaint. The court was even unimpressed by the guilty plea allocutions of WorldCom executives in which they confessed that they had concealed their falsification of WorldCom's books from Andersen.

Similarly, in *In re Homestore.com Inc. Securities Litigation*,[12] the court sustained a complaint that apparently did little more than identify red flags that might have enabled PwC to detect the fraud, such as major transactions taking place within the last few days of the quarter. Like the court in WorldCom, the U.S. District Court for the Central District of California was clearly influenced by the size of the earnings restatement ($193 million), and found its way to scienter, reasoning that the failure to catch the fraud had to surpass even gross negligence.

Conclusion

Plainly, both lawmakers and judges view the burden to the auditor of defending against securities litigation very differently in 2003 from the way in which they viewed that burden in 1995. The marked drop in dismissals of such claims since Enron and the passage of Sarbanes-Oxley,[13] suggests that courts may be treating vague pleadings against auditors more leniently than in the past.

Nevertheless, the social cost of allowing baseless claims against auditors to proceed cannot be measured solely in dollars. For example, if the law allows such claims to survive judicial scrutiny too easily, the incentives for an auditor to undertake an engagement for a distressed company will be correspondingly quite low.

If auditors are the "gatekeepers" of financial reporting, the temptation to punish them simply for failing to outfox dishonest clients must still be resisted, lest someday the "Big Four" be pared down to the "Big Three."

As the remaining cases return for review on motions for summary judgment, courts should sustain only those actions against the accounting profession where they can clearly discern the "when, where, who and why" of a violation of auditing standards.

(1) See *Press v. Chemical Investment Services Corp.*, 166 F.3d 529, 537-38 (2d Cir. 1999).
(2) *SEC v. Price Waterhouse*, 797 F.Supp. 1217, 1240 (S.D.N.Y.1992).
(3) 17 C.F.R. 210.4-01(1) (2003).
(4) 101 F.3d 263, 270 (2d. Cir. 1996).
(5) See *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F.Supp. 112, 121-22 (S.D.N.Y.1974), rev'd in part on other grounds, 540 F.2d 27 (2nd Cir.1976).
(6) 235 F.Supp.2d 549, 677-685 (S.D. Tex. 2002).
(7) 148 F.Supp.2d 331 (S.D.N.Y. 2001).
(8) 288 F.3d 385, 388 (9th Cir. 2002).
(9) 253 F.Supp.2d 102 (D. Mass. 2003).
(10) 253 F.Supp.2d at 133-4 (quoting *Kenilworth Partners L.P. v. Cendant Corp.*, 59 F.Supp. 2d 417, 429 (D.N.J. 1999)).
(11) 2003 WL 21488087 (S.D.N.Y. 2003), Fed. Sec. L. Rep. (CCH) ¶92,450 (June 25, 2003).
(12) 252 F.Supp.2d 1018 (C.D. Cal. 2003).
(13) Nera Economic Consulting, Recent Trends in Securities Class Action Litigation, at 5-6; 9-10 (June 2003).