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SECOND CIRCUIT REVIEW

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Auditor Fails to Plead Primary Violation, Loss Causation

In this month's column, we report on *Lattanzio v. Deloitte & Touche LLP*,[1] a significant decision issued earlier this month by the U.S. Court of Appeals for the Second Circuit, affirming the dismissal of securities fraud claims against Deloitte & Touche LLP (Deloitte), the "Big Four" auditing firm.

In a unanimous opinion by Chief Judge Dennis G. Jacobs, joined by Circuit Judge John M. Walker Jr. and retired Supreme Court Justice Sandra Day O'Connor (sitting by designation), the Court of Appeals affirmed District Court Judge Miriam Cedarbaum's dismissal of securities fraud claims asserted against Deloitte for failure to plead a primary violation under *Central Bank* and failure to plead loss causation, among other grounds.

The court ruled that an outside auditor must make an actionable misstatement in order to be liable under §10(b), which was not alleged by plaintiffs here, and that assisting in the drafting of a filing is not sufficient to establish §10(b) liability. The court also ruled that the auditor's "going concern" warning, combined with precipitous adverse changes in the company's financial situation apparent on the face of the financial statements, made it "unambiguously apparent" that the company faced a risk of bankruptcy, even if the underlying financial information was inaccurate, and demonstrated that the auditor's misstatements did not proximately cause plaintiffs' damages.

Background and Procedural History

Plaintiffs filed suit on behalf of a putative class of purchasers of the stock of Warnaco Group Inc. (Warnaco) between Aug. 15, 2000 and June 8, 2001. Plaintiffs initially brought claims against Warnaco and several of its officers and directors, but later amended their complaint to add Deloitte & Touche LLP (Deloitte). Deloitte had served as Warnaco's outside accountant from November 1999 through the end of the class period. Deloitte moved to dismiss the claims against it under FedRCivP 9(b) and 12(b)(6). After the initial claims were dismissed without prejudice, plaintiffs filed an amended complaint and Deloitte again moved to dismiss the claims. At oral argument on Deloitte's motion to dismiss, Judge Cedarbaum "instructed plaintiffs to file another amended complaint which clearly sets forth the allegations against Deloitte, and reserved decision on Deloitte's motion."[2] Plaintiffs then filed a 116-page second amended complaint.

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Plaintiffs alleged that in the months leading up to Warnaco's June 11, 2001 bankruptcy filing, "Warnaco had defaulted on its credit agreements, had failed to obtain waivers from its creditors, and had seen its stock price plunge to 'almost zero.'"[3] Plaintiffs alleged that Deloitte knowingly made a number of affirmative misstatements concerning Warnaco's financial condition during the class period, and failed to correct misstatements made before the class period, even after discovering that they were false. Plaintiffs asserted that—as a result of Deloitte's misstatements—the risk of Warnaco's financial collapse had been concealed, resulting in the loss of the value of their shares when Warnaco filed for bankruptcy.

Plaintiffs' allegations focused on three sets of Warnaco financial documents: (1) the 1999 Form 10-K and amendments, (2) three quarterly statements filed during the class period, and (3) the 2000 Form 10-K.

Plaintiffs alleged that the 1999 Form 10-K overstated total shareholder equity by $30 million—$563 million instead of $533 million. Deloitte allegedly became aware of $26 million of the misstatement, which was attributable to improper chargebacks in February 2000, but did not correct Warnaco's financial statements until March 2001. Deloitte also allegedly became aware of the balance of the misstatement in the fall of 2000, but did not correct the company's financials until August 2001, after Warnaco had already filed for bankruptcy.

Warnaco filed 10-Qs in August 2000, November 2000, and May 2001. Plaintiffs alleged that these quarterly statements again overstated total shareholder equity, in addition to containing other errors. While these quarterly statements were not audited by Deloitte or accompanied by an audit opinion, federal securities regulations required Deloitte to "review" the 10-Qs.[4] Plaintiffs alleged that Deloitte reviewed the statements and was aware of the misstatements, but again did nothing to correct them.

Finally, plaintiffs alleged that the 2000 Form 10-K misrepresented Warnaco's total shareholder equity by $50 million—$77 million instead of $27 million. The 2000 Form 10-K contained Deloitte's audit opinion, wherein Deloitte stated that it had audited Warnaco's balance sheet "in accordance with auditing standards generally accepted."[5] Deloitte's audit opinion expressly warned that Warnaco "was not in compliance with certain covenants of its long-term debt agreements…and has a working capital deficiency…. These matters raise substantial doubt about its ability to continue as a going concern."[6]

The Second Circuit Decision

The Second Circuit affirmed the district court's judgment of dismissal on the basis of the lower court's "thorough and well-reasoned opinion," concluding that "Deloitte was not liable for Warnaco's quarterly statements, which it did not

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audit" and that "Deloitte had no duty during the class period to correct statements or misstatements made by Deloitte prior to the class period."[7] With respect to Deloitte's alleged misstatements concerning the 1999 and 2000 10-Ks, the court ruled that plaintiffs had inadequately pled loss causation.

No Primary Violation

The Supreme Court in *Central Bank of Denver v. First Interstate Bank of Denver, N.A.*, 511 US 164 (1994), ruled that there is no private right of action for aiding and abetting a §10(b) violation and emphasized that §10(b) reaches only "primary violators" of the federal securities laws. The court went on to hold that §10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."

Against this backdrop, the Second Circuit in *Lattanzio* held that "to state a §10(b) claim against an issuer's accountant, a plaintiff must allege a misstatement that is attributed to the accountant 'at the time of its dissemination,' and cannot rely on the accountant's alleged assistance in the drafting or compilation of a filing." The court observed that it is dispositive that the "accountant's assurances were never communicated to the public." What is critical—and what is not alleged by plaintiffs here—is that there be an actionable misstatement made by Deloitte. It is not sufficient to impose §10(b) liability, under the standards articulated by the court, for Deloitte to have worked on allegedly false filings for an issuer or even to have understood and appreciated the falsity of those filings. As the court expressly held, if the financial statements cannot be attributed to Deloitte, then they cannot form the basis for §10(b) liability.

No Loss Causation

The Supreme Court's seminal 2005 loss causation ruling, *Dura Pharm., Inc. v. Broudo*, "rejected the theory that artificial inflation of a security's purchase price is, without more, sufficient to establish loss causation."[8] Although the *Dura* court went on to observe 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,"[9] the Supreme Court did not detail what allegations would be sufficient to plead loss causation.

In *Lentell v. Merrill Lynch & Co.*—decided by the Second Circuit shortly before the Supreme Court issued its decision in *Dura Pharmaceuticals*, and authored by Judge Jacobs, who also authored *Lattanzio*—the court "held that a plaintiff could plead loss causation either by alleging that (1) the market reacted negatively to a corrective disclosure regarding the falsity of the defendant's misstatements, or (2) that the defendant misstated or omitted risks that did lead to the loss."[10] The *Lentell* court explained that "[l]oss causation is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff."[11] Loss causation is related to the concept of proximate cause, and a misstatement "is the 'proximate cause' of an investment loss if the risk that caused the loss was within the zone of risk concealed by the misrepresentations…alleged by a disappointed investor."[12]

The Second Circuit in *Lattanzio* ruled that plaintiffs failed to plead a sufficient connection between Deloitte's misstatements and the losses suffered as a result of Warnaco's bankruptcy. The court rejected plaintiffs' argument that the relevant risk concealed by the alleged misrepresentations was that Deloitte's audits were not conducted in accordance with generally accepted accounting practices; the relevant risk was Warnaco's bankruptcy. As a result, in order to state a claim, plaintiffs were required to allege that Deloitte's misstatements concealed the risk of Warnaco's bankruptcy.

Analyzing the allegedly misstated financial statements on their face, the court found that the risk of Warnaco's bankruptcy was not "altogether concealed."[13] First, the court noted that the public financial statements disclosed that Warnaco's reported total shareholder equity had decreased from $563 million in May 2000 to $35 million in May 2001, a 94 percent loss that indicated that "[c]learly, Warnaco could not continue for very long in this direction."[14] Second, Deloitte had expressly warned in the 2000 10-K that Warnaco was "not in compliance with certain covenants of its long-term debt agreements," and that there was "substantial doubt" regarding Warnaco's "ability to continue as a going concern."[15] The court found that Deloitte's "going concern" warning, which it characterized as an "ominous alarm," when accompanied by the "collapse" in Warnaco's total shareholder equity, made it "unambiguously apparent" that Warnaco faced a risk of bankruptcy.

The Second Circuit in *Lentell* held that where, as here, the allegedly fraudulent statement itself disclosed "substantial indicia" of the risk of loss, a plaintiff could still plead loss causation by alleging "(i) facts sufficient to support an inference that it was defendant's fraud—rather than other salient factors—that proximately caused plaintiff's loss; or (ii) facts sufficient to apportion the losses between the disclosed and concealed portions of the risk that ultimately destroyed an investment."[16]

Applying the *Lentell* framework, the court examined the misstatements attributed to Deloitte, and concluded that they were "fewer," "more sporadic" and "less egregious than Warnaco's misstatements."[17] Accordingly, the court ruled that plaintiffs failed to allege loss causation, as they failed to allege facts sufficient (1) to show that Deloitte's misstatements—as opposed to Warnaco's—were the proximate cause of plaintiffs' loss, and (2) to assign "some rough proportion of the whole loss to Deloitte's misstatements."[18]

Conclusion

The Second Circuit's ruling in *Lattanzio* is quite significant. Though it has not received much attention, the ruling should substantially benefit defendants (especially in the Second Circuit) facing securities fraud claims. The *Lattanzio* court addresses two of the most potent defenses available to defendants in securities fraud class actions—the "primary violation" and "loss causation" defenses—and adopts a pro-defense stance with respect to each. The court reinforced that a defendant must "make" a misrepresentation, or that a misrepresentation must be "attributable" to a defendant, to support §10(b) liability. Likewise, the Second Circuit's discussion of loss causation creates substantial obstacles for plaintiffs seeking to state a securities fraud claim. Interestingly, the Court, even with Justice O'Connor on the panel, did not cite the Supreme Court's 2005 seminal loss causation ruling in *Dura*; rather it cited and analyzed the circuit's earlier (and arguably more stringent) 2005 ruling in *Lentell*.

The circuit in *Lattanzio* has provided district courts with substantial ammunition to dismiss—at the pleading stage—securities fraud class actions against secondary actors, even in the context of a bankrupt issuer. It will be interesting to see if district courts follow the circuit's lead.

1. __F3d__, 2007 WL 259877 (2d Cir. Jan. 31, 2007).
2. *In re The Warnaco Group, Inc. Securities Litigation*, 388 FSupp2d 307, 309 (SDNY 2005).
3. *Lattanzio*, 2007 WL 259877, at *1.
4. 17 CFR §210.10-01(d).
5. *Lattanzio*, 2007 WL 259877, at *3.
6. Id.
7. Id. at *1. The court also affirmed the district court's dismissal of a breach of fiduciary duty claim. Id. at *9.
8. *Dura Pharm., Inc. v. Broudo*, __US__, 125 SCt 1627, 1629, 161 L.Ed.2d 577 (2005).
9. *In re The Warnaco Group, Inc.*, 388 FSupp2d at 317, citing *Dura Pharm., Inc.*, 125 S. Ct. at 1634.
10. Id. at 317, citing *Lentell*, 396 F.3d 161, 175 (2d Cir. 2005).
11. *Lattanzio*, 2007 WL 259877 at *7, citing *Lentell*, 396 F.3d at 172.
12. Id., citing *Lentell*, 396 F3d at 173.
13. Id. at *8.
14. Id.
15. Id.
16. *Lentell*, 396 F.3d at 177.
17. *Lattanzio*, 2007 WL 259877, at *8.
18. Id. at *9