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Second Circuit Review

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Securities Fraud: Accountant May Be Primarily Liable

In last month's column, we reported on the *Lattanzio* case, where the U.S. Court of Appeals for the Second Circuit ruled that, in the circumstances presented in that matter, alleged omissions by an auditor did not give rise to primary liability for securities fraud.

In this month's column, we report on the Second Circuit's decision in *Overton v. Todman & Co.*,[1] where the court ruled that an auditor's alleged failure to correct a false or misleading certified opinion or financial statement may give rise to primary liability for securities fraud.

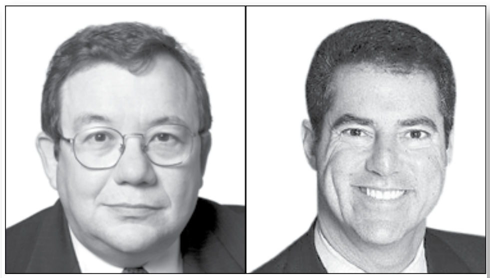
The 'Overton' Holding

In *Overton*, the Second Circuit, in a unanimous opinion written by Judge Chester J. Straub, joined by Judges Amalya L. Kearse and Joseph M. McLaughlin, addressed an increasingly important concern to which the court has only alluded in the past: that an accountant's failure to correct its certified opinion or financial statement may, in certain circumstances, give rise to a primary violation of the federal securities laws. The court held that an accountant violates its duty to correct when it makes a statement in its certified opinion that is false or misleading when made, subsequently learns or was reckless in not learning that the earlier statement was false or misleading, knows or should know that potential investors are relying on the opinion or financial statement, and then fails to take reasonable steps to correct or withdraw its opinion or the financial statement.

Under such circumstances, assuming the other requirements for a securities fraud claim are satisfied, an accountant becomes primarily liable under §10(b) of the Securities Exchange Act of 1934[2] and SEC Rule 10b-5.[3]

Background and Procedural History

According to the complaint, defendant Todman & Co. (Todman) audited the financial statements of Direct Brokerage Inc. (DBI), a registered securities broker-dealer. For each of the years from 1999 to 2002, Todman rendered an unqualified opinion that DBI's financial statements accurately portrayed the company's fiscal health. In 2003, however, the



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New York State Division of Taxation contacted DBI about unpaid payroll taxes dating back to 1999 and determined that DBI owed more than $3 million in taxes, interest, and penalties. DBI later began its own internal investigation that revealed that its former CFO failed to record the payroll tax liabilities on the company's books and that Todman's audits had been deficient.

To keep afloat, DBI turned to outside investors. Plaintiff Overton was among those solicited to invest in DBI. In connection with the investment solicitation, Overton received DBI's 2002 financial statements and, it is alleged, relied principally on the audited financial statements certified by Todman before investing a substantial sum in the company. Three months later, DBI collapsed under the weight of its liabilities.

Based on these allegations, Overton asserted federal securities fraud and pendant state law claims against Todman. Overton's claim for securities fraud alleged that Todman became aware of the events relating to the discovery of DBI's undisclosed liability, that it knew of DBI's efforts to secure new capital, and that it knew DBI's financial statements would be provided to potential investors. Despite Todman's asserted knowledge of these events, Overton contended that Todman never took any steps to withdraw its certification or instruct DBI not to disclose the financial statements. Overton did not allege, however, that Todman initially conducted its audit recklessly.

Judge John E. Sprizzo of the U.S. District Court for the Southern District granted Todman's motion to dismiss for failure to state a claim.[4] The district court explained that under the Supreme Court's ruling in *Central Bank of Denver v. First Interstate Bank of Denver*,[5] §10(b) and Rule 10b-5 impose liability only on those who actually make material statements or omissions, not on mere aiders and abettors. Thus, accountants could only be liable for their omissions, if at all, under a theory of primary liability. Although the district court conceded that a Second Circuit case, *Wright v. Ernst & Young LLP*, stated that "[a]ccounting firms 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,"[6] the court did not consider this to be a binding statement of an accountant's duties under the federal securities laws. First, the district court characterized the passage as dicta. Second, the court stated that this passage quoted an earlier Second Circuit case discussing aiding and abetting liability under federal securities law, and that, because *Central Bank* eliminated such aiding and abetting liability, the passage is no longer good law. Finally, the court noted that DBI was a closely held corporation whose stock was not traded on a public exchange.

Second Circuit Decision

The Second Circuit reversed the district court judgment. The court first observed that in securities fraud cases, before an individual may be liable for his silence, "he must have an underlying duty to speak."[7] The Second Circuit acknowledged that, although it had alluded to accountants having such a duty in previous cases, it had never squarely held that such a duty exists.

According to the Second Circuit, the first case referring to an accountant's duty to correct its certified opinion was *ITT v. Cornfeld*. In *Cornfeld*, the court considered whether an auditor could be liable as an aider and abettor where it certified the financial statements for a mutual fund and later found out, but did not disclose, that there existed a conspiracy between the mutual fund and a complex of companies. The court held that accountants have a duty to take reasonable steps to correct misstatements they have discovered in previous certified financial statements on which they knew the public was relying, but limited this duty to only those statements that the accountant actually prepared and certified. Because the information the plaintiffs in *Cornfeld* claimed the accountant should have disclosed—the conspiracy—was not a correction of anything in the certified statements, the auditor had no duty to disclose it, and the claim was dismissed.

Fourteen years later, in *Central Bank*, the Supreme Court held that §10(b) does not authorize aiding and abetting liability because, under that section, an actor must himself make a material misstatement or omission or commit a manipulative act. In so holding, however, the Supreme Court did not foreclose that secondary actors such as accountants may be liable for their omissions. The Court noted:

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The absence of §10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the Securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.[8]

'Shapiro v. Cantor'

Shortly after *Central Bank* was decided, the Second Circuit again addressed the issue of an accountant's duty to correct a certified statement, in *Shapiro v. Cantor*.[9] There, the court ruled that an accountant alleged to have provided financial projections that were later included in the principal defendants' offering memoranda was not liable for securities fraud based on its failure to disclose that one of the principals was a convicted felon and his 12-year-old son was the sole officer, director, and shareholder of a managing entity. In so holding, the court reasoned that the duty to disclose arises only "when one party has information that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."[10] Whereas an accountant's issuance of a certified opinion would trigger the duty to disclose a fraud because of the public's expectations and reliance on the opinion, no such duty exists where the accountant issues no public opinion about a company, but merely conducts internal audits or reviews for the company.

The following year, in *Wright v. Ernst & Young*, the Second Circuit again addressed in dicta an accountant's duty to correct a certified statement. On appeal, the plaintiff in *Wright* argued for the first time that an accountant was primarily liable for securities fraud because it had discovered facts tending to undermine the accuracy of its earlier report and knew that the market was relying on its report, yet failed to correct it. The Second Circuit agreed in principle with this theory of liability, reiterating its view that accounting firms 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. The court further noted that "[s]ilence where there is a duty to disclose can constitute a false or misleading statement within the meaning of §10(b) and Rule 10b-5."[11] Because the plaintiff did not preserve this issue on appeal, however, the court affirmed the dismissal of her complaint.

Finally, the *Overton* court noted that the Second Circuit had very recently discussed an accountant's duty to correct its certified opinion in *Lattanzio v. Deloitte & Touche LLP*.[12] There, the Second Circuit assumed the existence of such a duty, but did not decide the issue because the other requirements of a securities fraud claim were not met in that case.

In light of these prior decisions, the Second Circuit in *Overton* held that an accountant's duty to correct its certified opinions exists, and that the violation of such duty gives rise to primary liability under §10(b) and Rule 10b-5. Specifically, the court held:

> an accountant violates the "duty to correct" and becomes primarily liable under §10(b) and Rule 10b-5 when it (1) makes a statement in its certified opinion that is false or misleading when made; (2) subsequently learns or was reckless in not learning that the earlier statement was false or misleading; (3) knows or should know that potential investors are relying on the opinion and financial statements; yet (4) fails to take reasonable steps to correct or withdraw its opinion and/or the financial statements; and (5) all the other requirements for liability [such as materiality, transaction causation, loss causation, and damages] are satisfied.[13]

The Second Circuit reasoned that this holding comports not only with its prior precedent, but also with other relevant authorities. First, the language of §10(b) and Rule 10b-5 shows that those provisions broadly prohibit "any person," including accountants and other secondary actors, from engaging in fraud by means of a materially misleading omission. Second, the holding comports with *Central Bank* because it requires both the accountant to make its own misleading omission (thus complying with the prohibition on aiding and abetting liability), and the potential investor to rely on the accountant's omission. Finally, the holding comports with various secondary authorities indicating that an accountant becomes primarily liable under §10(b) and Rule 10b-5 for failing to correct known errors in certified opinions or financial statements.

In light of prior decisions, the Second Circuit in 'Overton' held that an accountant's duty to correct its certified opinions exists and violation of such duty gives rise to primary liability under §10(b) and Rule 10b-5.

Three Key Limits

The Second Circuit explained that there are three important limits to its decision.

- First, the court held that an accountant only has a duty to correct its prior certified statements, not a broader duty to update those statements. Thus, an accountant need only correct statements that were false when made, not those that were made misleading by intervening events.
- Second, an accountant need correct only those particular statements set forth in its opinion or certified financial statements. Unless an accountant exchanged its role for that of an insider, it is under no duty to divulge information collateral to the statements of accuracy and financial fact set forth in its opinion and the certified financial statements.
- Finally, the Court noted that its holding is limited to those circumstances where an accountant (1) makes a statement in its certified opinion that is false or misleading when made; (2) subsequently learns or was reckless in not learning that the earlier statement was false or misleading; and (3) knows or should know that potential investors are relying on its opinion.

Under those circumstances, if an accountant fails to take reasonable steps to correct or withdraw its certified opinion or the underlying financial statements, it becomes primarily liable for a misleading omission under §10(b) and Rule 10b-5, assuming all other elements of liability are present.

Based on these principles, the Second Circuit ruled that plaintiff's complaint adequately stated a claim of primary accountant liability under §10(b) and Rule 10b-5 against Todman. The court also ruled that DBI's status as a closely held corporation did not affect the applicability of §10(b) and Rule 10b-5.

Conclusion

The Second Circuit's ruling in *Overton* may aid plaintiffs in securities fraud cases seeking to impose liability on secondary actors, particularly accountants. These secondary actors, in certain specified circumstances, now have an affirmative duty to correct their false or misleading statements even after those statements have been issued. Importantly, this duty arises regardless of whether the secondary actors were reckless in preparing their statements in the first instance.

Moreover, because a reckless failure to learn that a prior statement was false or misleading will not excuse a failure to correct that prior statement, the court's decision requires secondary actors to keep apprised of the accuracy of their past statements. After *Overton*, any person involved in the securities markets must proceed with great care not only when assisting clients with documents that will be provided to potential investors, but must also continue to monitor carefully their statements and the circumstances related to those statements afterwards to ensure that they were not false when made.

While the Second Circuit in the past month has issued two decsions addressing the scope and contours of *Central Bank*, as it pertains to auditors, the U.S. Court of Appeals for the Fifth Circuit last week stole the *Central Bank* thunder. In Enron securities class action, the Fifth Circuit, in a sharply divided Rule 23(f) panel opinion, held that under *Central Bank* the bank defendants' conduct constituted only aiding and abetting and did not give rise to primary liability under Rule 10b-5. That issue—involving the scope of *Central Bank*—is pending before the Supreme Court and *Central Bank* may well be clarified in the next year.

1. __F3d__, 2007 WL 574623 (2d Cir. 2007).
2. 15 USC §78j(b).
3. 17 CFR §204.10b-5.
4. 2006 WL 1153307 (SDNY May 2, 2006).
5. 511 US 164 (1994).
6. 152 F3d 169, 177 (2d Cir. 1998) (quoting *ITT v. Cornfeld*, 619 F2d 909, 927 (2d Cir. 1980).
7. *Overton*, 2007 WL 574623 at *4 (citing *Chiarella v. United States*, 445 US 222, 227-28 (1980)).
8. *Central Bank*, 511 US at 191, quoted in *Overton*, 2007 WL 574623 at *5.
9. 123 F3d 717 (2d Cir. 1997).
10. Id. at 721, quoted in *Overton*, 2007 WL 574623 at *6.
11. 152 F3d at 177, quoted in *Overton*, 2007 WL 574623 at *7.
12. 476 F3d 147 (2d Cir. 2007).
13. 2007 WL 574623 at *8.