"A court expands accountants' liability"

In February, the U.S. Court of Appeals for the Second Circuit reversed a lower court decision and held a closely held corporation's auditor primarily liable under Sec. 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5.

Specifically, in Overton v. Todman & Co. CPAs PC, the court held that an auditor may incur primary liability when the auditor makes a statement in its certified opinion that is false of 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, and yet fails to take reasonable steps to correct or withdraws its opinion and/or the financial statements.

Given the paramount role that audits play for nearly every business in this country, the Overton decision could have broad consequences for all accountants and the businesses that they audit.

A FLAWED AUDIT REPORT

Direct Brokerage Inc. was a registered broker/dealer, which from 1999 to 2002 employed Todman & Co, CPAs as its independent auditor. Todman issued an unqualified audit report every year. In early 2003, the New York State Division of Taxation and the New York City District Attorney's office notified DBI that it owed more than $3 million in unpaid payroll taxes, interest and penalties. That summer, DBI hired forensic accounting firm, which found that Todman's audits had been deficient and had "deviated materially" from generally accepted auditing standards.

Because it was hovering close to bankruptcy that year, DBI sought investors and capital. The most interested was David Overton, the plaintiff. To help Overton decide whether to invest, DBI gave him its 2002 audited financial statement, which Todman had issued in February 2003. According to the complaint, Todman knew not long thereafter that the 2002 financial statements was inaccurate, that DBI needed money, and that the company was actively seeking lenders and investors.

In early 2004, Overton invested $500,000 in DBI and loaned the company and additional $1.5 million. Several months later, DBI defaulted on the loan and Overton lost his entire investment. He then sued Todman and its successors in interest, Trien, Rosenberg, Rosenberg, Weinberg, Ciullo & Fazzari LLP, alleging that the firm violated Sec. 10(b) and Rule 10b-5 by remaining silent when it knew that the 2002 financial statement that it certified had material errors. Overton argued that Todman knew that potential investors would rely on its professional opinion in making an investment decision. Todman moved to dismiss the complaint.

DISMISSING THE COMPLAINT

The district court granted Todman's motion to dismiss, holding that the auditor had no duty to notify Overton that the financial statement was inaccurate. The court explained that Overton's claims failed as a matter of law, because Overton neglected to allege that Todman's audits were fraudulent, that its statements were knowingly false when they were made, of that Todman's work was otherwise actionable under the federal securities laws.

The court noted that, in effect, Overton argued for a rule that would indefinitely require a closely held corporation's outside auditor to notify an entire unknown class whenever a financial statement, neither fraudulently nor recklessly prepared, is no longer accurate. The court rejected that rule.

VACATING THE DISMISSAL

Vacating the district court's decision to dismiss Overton's complaint, the Second Circuit held that an accountant violates the "duty to correct" past statements and becomes primarily liable under Section 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 are satisfied" (such as materiality, transaction causation, loss causation and damages).

The Second Circuit's opinion stated that it comports with the Supreme Court's decision in Central Bank of Denver v. First Interstate Bank of Denver that Sec. 10(b) does not authorize aiding and abetting liability, in two crucial respects: "First, we remain true to the prohibition on aiding and abetting liability because we require that an accountant make its own misleading omission by failing to correct its certified opinion. Second, we require, as a component of the underlying duty to correct, what Central Bank labeled a 'critical' element under Sec. 10(b) and Rule 10b-5: reliance by potential investors on the accountant's omission."

By bolting its opinion to Central Bank, the Second Circuit declared that the auditor's conduct was just a culpable as that of the company that fabricated its financial statements. Thus now, in the Second Circuit, and auditor that does not correct known errors – or errors it should have known – is just as liable as the company that made the error. This casts a wide net of liability.

LEGAL REASONING FROM PRIOR CASES

Though the holding appears to contort the definition of primary liability beyond judicial precedent, the court's opinion stresses that it follows decisions that the Second Circuit would have reached if it had the opportunity, but the parties failed to put the issue before the court.

In IIT v. Cornfield, the court examined whether a plaintiff could hold an auditor – Arthur Andersen & Co. – liable for aiding and abetting securities fraud by failing to disclose the existence of a raiding conspiracy between a mutual fund and a complex of companies. Andersen issued certified financial statements that failed to reveal the conspiracy. Plaintiffs alleged that the accounting firm, having certified the financial statements, had a duty to disclose this information as it became known, and that violating that duty rendered the accountant liable as an aider and abettor to securities fraud.

The Overton court explained that the Cornfeld panel "recognized that 'accountants do have a duty to take reasonable steps to correct misstatements they have discovered in previous [certified] financial statements on which they know the public is relying.'" However, Overton noted that Cornfeld limited this duty to solely those statements that the accountant actually prepared and certified. "Since the information that the plaintiffs 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." Because the plaintiff pled only aiding and abetting liability, “we had no opportunity or reason to consider whether primary liability could arise from a violation of the duty to correct and did not reach that issue.”

Overton noted that the Second Circuit also addressed the issue – though again only obliquely – several times in the 1990s.

A year later, in Wright v. Ernst & Young LLP, a plaintiff alleged on appeal – raising the issue for the first time – that the accountant could be primarily liable because it had “discovered facts tending to undermine the accuracy” of its earlier audit report, it knew that the market was relying on the report, and it failed to correct the report. The Overton court noted that the Wright panel “agreed in principle with this theory of liability” and wrote that “accounting 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.’”

Nevertheless, the court held that the plaintiff failed to plead this theory in the amended complaint, and waived her chance to file a second amended complaint.

THE EFFECT

What effect will the decision have? The Overton court noted that, “Importantly, we hold only that an accountant has a duty to correct its prior certified statements, as opposed to broader duty to update those statements.”

This distinction is vital because, “The duty to correct requires only that the accountant correct statements that were false when made. In contract, the duty to update requires an accountant to correct a statement made misleading by intervening events, even if the statement was true when made.”

This means that an auditing firm must correct only those statements that were contemporaneously wrong; not those that later events made incorrect. The holding that accountants must only correct, and not update, audit reports and certifications might limit the holding somewhat. And accountants must remember this distinction when responding to a plaintiff's potentially overly broad complaint.

Yet because accounting firms audit hundreds of companies every year, the Second Circuit's Overton opinion may expose firms to potentially expensive liability. The decision will probably at least increase the number of suits filed, if not necessarily trigger widespread litigation. In response, and to reduce their risk, firms must continue to conduct their audits as vigorously as possible.

But this may not be enough. They must also monitor developments in the seemingly expanding field of accountant liability, and decide if tools such as aggressive motions to dismiss, and even amicus briefs, can curtail the expansion.

Firms must also seek guidance on how to comply with the holding. The court's opinion requires an accounting firm "to take reasonable steps to correct or withdraw its opinion and/or the financial statements." This requirement is at best ambiguous for several reasons.

First, what are "reasonable steps"? Does the accounting firm have to threaten to withdraw from future engagements if the company refuses? Must the audit partner notify the SEC? Second, how should a firm correct or withdraw its opinion? Do the accountants make a "noisy withdrawal" and publish their decision in a newspaper? That seems draconian, but logical if the goal is to notify investors, such as Mr. Overton. Barring congressional intervention, these answers will arrive via case law.

Accountants would be wise to discuss these issues with their legal advisors.