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Stuck Between a Rock and a Hard Place: Are Public Accounting Firms Subject to Diverging Standards of Conduct between Federal Courts and the PCAOB in Securities Fraud Claims?

In Tellabs v. Makor,[1] *the United States Supreme Court considered whether the Sarbanes-Oxley Act's Section 404(b) certification by a public accounting firm, in combination with other evidence, impacts the likelihood of a judicial finding of a "strong inference of scienter" required by the PSLRA to survive a pre-trial motion to dismiss a securities fraud claim against the public accounting firm.*

> "*Sarbanes-Oxley costs the American people money. It costs jobs. It costs our competitiveness. It hurts our markets.*"[2]

> "*The dirty little secret is that many CFOs love [Section] 404.*"[3]

> "*[A]ccounting firms simply cannot withstand an indictment. Can anyone say 'The Big Three?'*"[4]

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1. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007).
2. Robert Schroeder, *Group Sues over Governance Law: Challenge Mounted to Sarbanes-Oxley Act,* MARKETWATCH.COM. (Feb. 8, 2006, 4:35 PM), http://www.marketwatch.com/story/group-targets-corporate-governance-law-via-lawsuit (announcing a lawsuit by the Free Enterprise Fund challenging the constitutionality of the Public Company Accounting Oversight Board).
3. Amy Borrus, *Learning to Love Sarbanes-Oxley, A Few Companies Have Discovered that Compliance Actually Helps to Cut Costs*, BUS. WK., Nov. 21, 2005, at 128.
4. Joseph Nocera, *Auditors: Too Few to Fail*, N.Y. TIMES, June 25, 2005, at C1.

I. INTRODUCTION

Since the Public Company Accounting Reform and Investor Protection Act of 2002 (the "Sarbanes-Oxley Act") became law on July 30, 2002[5] following a wave of corporate scandals at large corporations like Enron, Worldcom, Cendant, or Bristol-Myers Squibb,[6] the controversy surrounding the so-called "section 404"[7] has been one of the most debated and argued provisions of the new law. Supporters of the Sarbanes-Oxley Act, mostly investor groups and the plaintiffs bar, battle representatives of the business community who support the loosening of the Sarbanes-Oxley Act or a wider deregulation in the field of federal securities law.[8] Arguments on either side of the securities market regulation debate involve enormous financial stakes and critical policy questions: skyrocketing compliance costs, crippling regulation, a lack of competitiveness of the U.S. vis-à-vis other exchanges on the one side,[9] compete with the need for corporate accountability and for transparency to ensure proper valuation of securities.[10] At the center of the debate, a "perfect storm" is forming around the public accounting firm,[11] which is statutorily entrusted to issue binding opinions on the truthfulness of the financial

5. *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).

6. *See Top Ten Settlements Post-Reform Act Securities Class Action Settlements*, Stanford Law Sch. Sec. Class Action Clearinghouse, http://securities.stanford.edu/top-ten.html (last visited Feb. 16, 2014); Kathleen F. Brickley, *From Enron to Worldcom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 Wash. U.L.Q. 357, 359–60 (2003) (describing the accounting issues appearing with both the Enron and Worldcom scandals and their impact on the development of the Sarbanes-Oxley Act of 2002); Matthew S. Mokwa, *Enron, Sarbanes-Oxley, and the End of Earnings Management*, 39 Tex. J. Bus. L. 325, 326 (2003) (describing the corporate practice of earnings management that has led to several accounting failures); Duke Helfand & Marc Lifsher, *California Lawsuit Accuses Bristol-Myers Squibb of Fraud, Kickbacks*, L.A. Times (Mar. 19, 2011), http://articles.latimes.com/2011/mar/19/business/la-fi-drug-kickbacks-20110319.

7. 15 U.S.C. § 7262 (2012).

8. *See Interim Report of the Committee on Capital Markets Regulation*, Comm. on Capital Mkts. Regulation 7 (Nov. 30, 2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (recommending that the SEC loosen capital controls for foreign issuers).

9. *See* Neal L. Wolkoff, *Sarbanes-Oxley Is a Curse for Small-Cap Companies*, Wall St. J., Aug. 15, 2005, at A13; Adriana Zea, *Sarbanes-Oxley to Create Litigation Nightmare*, AccountancyAge (Aug. 22, 2002), http://www.accountancyage.com/aa/news/1764223/sarbanes-oxley-create-litigation-nightmare; C. Koch, *Compliance- The Sarbanes-Oxley Conspiracy*, CIO (July 1, 2004), http://www.cio.com/article/29187/Compliance_The_Sarbanes_Oxley_Sarbox_Conspiracy; Steve Forbes, *Fact and Comment* (*Dump This Destructive Deadweight*), Forbes.com (Aug. 18, 2005, 6:00 PM), www.forbes.com/forbes/2005/0905/031.html.

10. *See* K. Alvarado, *Private Companies Embrace Sarbanes-Oxley*, 62 Internal Auditor, Aug. 2005, at 19; William J. McDonough, *Promoting Public Trust,* J. Pub. Inquiry, Fall/Winter 2004–05, at 4, *available at* http://www.ignet.gov/randp/fw04jpi.pdf; *Deloitte's Point of View*: *Sarbanes-Oxley Compliance*, Deloitte 7 (2004), http://www.deloitte.com/assets/Dcom-Israel/Local%20Assets/Documents/A%20Bridge%20to%20Excellence(1).pdf; Amey Stone, *SOX: Not So Bad After All?*, BusinessWeek.com (July 31, 2005), http://www.businessweek.com/stories/2005-07-31/sox-not-so-bad-after-all.

11. *See* 17 C.F.R. § 240.19d–4 (2010) (aligning the definition of "public accounting firm" to the definition that appears in 15 U.S.C. § 7201(a)(9) (2012), which states that a public accounting firm is "a proprietorship, partnership, incorporated association, corporation, limited liability company, limited liability partnership, or other legal entity that is engaged in the practice of public accounting or preparing or issuing audit reports").

disclosures by issuers registered on a U.S. Exchange.[12] This liability storm already claimed its first victim, Arthur Andersen,[13] which, following its involvement in the Enron scandal was criminally indicted[14] and then later convicted on obstruction of justice charges.[15] Following this conviction, on August 31, 2002, Arthur Andersen had to surrender its license to practice before the Securities and Exchange Commission ("SEC"),[16] effectively ending the company's operations.[17] A new front already opened in this liability storm with potential legal attacks against public

12. *See* 15 U.S.C. § 78j-1(a) (2012) (Section 10A of the 1934 Act requires the audit report to include procedures designed for the purpose of detecting illegal acts having a material impact on the financial statements, designed to identify related party transactions which are material to the financial statements, and an evaluation as to any doubt about the ability of the entity to continue as a going concern.).

13. *See* Ken Brown and Ianthe Jeanne Dugan, *Arthur Andersen's Fall From Grace Is a Sad Tale of Greed and Miscues,* WALL ST. J., June 07, 2002, at A1. The firm of Arthur Andersen was created in 1913 by Arthur Andersen and Clarence DeLany as Andersen, DeLany & Co. SUSAN E. SQUIRES ET AL., INSIDE ARTHUR ANDERSEN: SHIFTING VALUES, UNEXPECTED CONSEQUENCES 109 (2003). The firm changed its name to Arthur Andersen & Co. in 1918. In 1989, Arthur Andersen and Andersen Consulting became separate units of Andersen Worldwide. *Id.* at 30. The two organizations spent most of the 1990s in a bitter dispute, which ended in 2000, when Andersen Consulting gained its independence from Arthur Andersen against a $1.2 billion settlement and a change of name; as a result Andersen Consulting changed its name to Accenture. *Id.* at 92.

14. *See* Grand Jury Indictment, United States v. Arthur Andersen, LLP, No. CR H-02-121, 2002 WL 34718543 (S.D. Tex. Mar. 7, 2002). This was the first time that a criminal charge was ever brought against a major U.S. accounting firm. *See* Kurt Eichenwald, *Enron's Many Strands: The Investigation; Andersen Charged With Obstruction in Enron Inquiry*, N.Y. TIMES, Mar. 15, 2002, at A1.

15. *See* Greg Farrell, *Arthur Andersen Convicted of Obstruction of Justice*, USA TODAY (June 15, 2002, 2:10 PM), http://usatoday30.usatoday.com/money/energy/enron/andersen-verdict.htm. The conviction of Arthur Andersen was later unanimously reversed on May 31, 2005 in *Arthur Anderson, LLP v. United States*, where the Court held that the jury instructions were misleading as to the intent element of the obstruction of justice charge, and that the corrupt persuasion requirement of the obstruction of justice charge required a higher threshold of consciousness of wrongdoing. 544 U.S. 696, 706 (2005).

16. The Securities and Exchange Commission was created by Section 4 of the 1934 Act. 15 U.S.C. § 78d (2012); *see also The Laws that Govern the Securities Industry*, SEC, http://www.sec.gov/about/laws.shtml#secexact 1934 (last visited Jan. 15, 2014). The 1934 Act also authorizes the SEC to require audited financial statements in public periodic filings. 15 U.S.C. §§ 78l(b), 78m(a)(2) (2012); A.C. Pritchard, *The Irrational Auditor and Irrational Liability*, 10 LEWIS & CLARK L. REV. 19, 29 (2006) ("Although the SEC briefly flirted in its early years with the creation of uniform accounting principles under the leadership of Chairman William O. Douglas, it ultimately chose to delegate the formulation of generally accepted accounting principles and generally accepted auditing standards to the accounting industry. Financial statements filed with the SEC were required to be prepared in accordance with principles having 'substantial authoritative support.' In practice, that meant delegation of the promulgation of accounting principles and auditing standards to the accounting industry's trade association, now known as the American Institute of Certified Public Accountants (AICPA).").

17. *See* Kurt Eichenwald, *Andersen Guilty in Effort to Block Inquiry on Enron*, N.Y. TIMES, June 16, 2002, at A1; *see also* Cheryl D. Block, *Congress and Accounting Scandals: Is the Pot Calling the Kettle Black*, 82 NEB. L. REV. 365, 367 (2003) (referring to the collapse of Arthur Andersen); Ethan S. Burger, *Regulating Large International Accounting Firms: Should the Scope of Liability for Outside Accountants be Expanded to Strengthen Corporate Governance and Lessen the Risk of Securities Law Violations?*, 28 HAMLINE L. REV. 1, 2 (2005) (referring to the collapse of Arthur Andersen); James Kelly, *The Power of an Indictment and the Demise of Arthur Andersen*, 48 S. TEX. L. REV. 509, 517 (2006) (discussing "the death of Arthur Andersen"); Stephan Landsman, *Death of an Accountant: the Jury Convicts Arthur Andersen of Obstruction of Justice*, 78 CHI.-KENT L. REV. 1203, 1205 (2003) (addressing Enron's role in the collapse of Arthur Andersen).

accounting firms in the aftermath of the subprime lending crisis.[18] Troubling signs of significant exposure have already surfaced in the litigation pipeline,[19] and in the Public Company Accounting Oversight Board ("PCAOB") inspection reports.[20]

The public accounting firm fulfills a critical role, because it is considered to be the primary watchdog over the reporting entity, both on behalf of the investing public and on behalf of the regulatory authorities which enforce securities laws.[21] The Sarbanes-Oxley Act represented a significant change in the regulation process of the public accounting industry in several ways: the accounting profession is, for the first time, under the direct oversight of a government-sponsored organization, the PCAOB;[22] auditors are subject to new auditor independence and conflict of interest rules;[23] and Section 404 of Title IV of the Sarbanes-Oxley Act requires a management assessment of internal controls, which then must be tested and certified to by the public accounting firm in charge of certifying the financial

18. *See* Heather M. Tashman, *The Subprime Lending Industry: An Industry in Crisis*, 124 BANKING L.J. 407, 407–08 (2007) (summarizing the subprime lending crisis); Marie Leone, *Ex-Auditors Settle Securitization Charges,* CFO.COM (Sept. 21, 2007), http://ww2.cfo.com/accounting-tax/2007/09/ex-auditors-settle-securitization-charges/ (summarizing the subprime lending crisis on auditors).

19. *See, e.g., In re* Metro. Sec. Litig., 532 F. Supp. 2d 1260, 1271 (E.D. Wash. 2007).

20. PUB. CO. ACCOUNTING OVERSIGHT BD., RELEASE NO. 104-2007-129, REPORT ON 2006 INSPECTION OF PRICEWATERHOUSECOOPERS LLP 4–6 (Oct. 18, 2007), *available at* http://pcaobus.org/Inspections/Reports/Documents/2007_PricewaterhouseCoopers.pdf.

21. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 218 (1976) ("The critical importance of the auditing accountant's role in insuring full disclosure cannot be overestimated. The SEC has emphasized that in certifying statements the accountant's duty 'is to safeguard the public interest, not that of his client.'" (citing Touche, Niven, Bailey & Smart, 37 S.E.C. 629, 670–671 (1957)))*; see also* United States v. Benjamin, 328 F.2d 854, 863 (2d Cir. 1964) ("In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar. Of course, Congress did not mean that any mistake of law or misstatement of fact should subject an attorney or an accountant to criminal liability simply because more skillful practitioners would not have made them. But Congress equally could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess."); Arthur Levitt, Chairman, SEC Address at the Fall Council of the American Institute of Certified Public Accountants (Oct. 24, 2009), *available at* http://www.sec.gov/news/speech/spch410.htm ("[The auditing profession is] a franchise that demands you defend and protect, above all else, the public trust; a franchise that asks you to stand firm—even under the weight of management's pressure to 'see things their way'").

22. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.). Title I establishes the Public Company Accounting Oversight Board and defines its mandate (registration and inspection of public accounting firms, definition of auditing standards, oversight of the SEC); Title II addresses the issues of auditor independence (services excluded from the practice of auditors, partner rotation rules, auditor reports to audit committees, conflict of interest rules); Title III addresses corporate responsibility (penalties on officers and directors, role of audit committees, rules of professional responsibility for attorneys); Title IV addresses the enhanced financial disclosure requirements, while Titles V through XI deal with various conflict and penalties issues. *Id.*

23. *See id.*

statements.[24] In this new environment, the public accounting industry is subject to two conflicting pressures: on one side, its mandate is to certify to the transparency and accuracy that investors seek when making investment decisions, and on the other it owes a duty to its client to manage and minimize the regulatory burdens.[25] In the midst of this conflict, public accounting firms are subject to the potential risk of considerable legal liability in private securities litigations, and, unlike other industries, have become the subject of a unique debate, where many agree that one cannot afford the bankruptcy or disappearance of another public accounting firm.[26]

For instance, following Bernard Madoff's guilty plea in March 2009 to eleven counts of offenses related the Ponzi scheme he facilitated through his investment advisory firm,[27] its independent auditor, David Friehling of Friehling & Horowitz

24. Following the passage of the Sarbanes-Oxley Act, an issuer and its public accounting firm are subject to three different periodic certifications requirements. First, under Section 302 of the act, the issuer must follow a set of internal procedures designed to ensure accurate financial disclosure. 15 U.S.C. § 7241 (2012). The signing officers must certify that they are "responsible for establishing and maintaining internal controls" and "have designed such internal controls to ensure that material information relating to the issuer is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared." 15 U.S.C. § 7241(a)(4) (2012). Second, under Section 906, the signing officers must attest to the fair representation of the financial condition and results of operations and face criminal penalties for misrepresentation. 18 U.S.C. § 1350 (2012). Both Section 302 and Section 906 overlap, but Section 302 "feeds into" the Section 906 certification. Third, under Section 404(a), management is required to produce an "internal control report" as part of each 10K Annual Report, which must attest to "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting." 15 U.S.C. § 7262(a) (2012). Under Section 404(b), external auditors are required to issue an opinion on whether effective internal control over financial reporting was maintained in all material respects by management. 15 U.S.C. § 7262(b) (2012). This is in addition to the financial statement opinion regarding the accuracy of the financial statements.

25. *See* United States v. Arthur Young & Co., 465 U.S. 805, 817–18 (1984) ("By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations."); *see also* Gregory L. Paul, *Not Biting the Hand That Feeds You: Public Accounting Firms and Conflicts of Interest*, 34 GOLDEN GATE U. L. REV. 325 (2004) (offering further analysis of *United States v. Arthur Young & Co.*).

26. *See* U.S. GEN. ACCOUNTING OFFICE, GAO-03-864, PUBLIC ACCOUNTING FIRMS, MANDATED STUDY ON CONSOLIDATION AND COMPETITION 1 (2003), *available at* http://www.gao.gov/new.items/d03864.pdf (showing that, in 2002, the vast majority of large corporations are audited by the "Big 4," i.e. PwC, Deloitte, Ernst & Young, and KPMG). One must also notice the short term economic benefit for public accounting firms represented by the considerable increase in revenues from Sarbanes-Oxley-related activities, including Section 404 control audits, and associated consulting activities. *See* Andrew J. Weidman, *Are We Failing the Exam?: Many Graduates Are Not Pursuing Their CPA Certificates* , ACCT. TODAY, Sept. 2006, at 29. ("If you look at the revenue growth of public accounting firms over the past couple of years, you will see that our industry is in the midst of an economic boom. According to a March 2006 special supplement to *Accounting Today* on the Top 100 Firms, over 75 percent of these firms experienced double-digit growth over the previous year.").

27. Seth L. Laver, *Bernie Madoff and Auditor Liability: Emerging Trends and Defenses* (2012) *available at* http://dritoday.org/feature.aspx?id=320.

CPAs was charged with securities fraud in March 2009.[28] The SEC's complaint alleged that Friehling aided and abetted under Section 10(b) and Rule 10b-5, among other things. Friehling agreed not to contest the SEC's charges.[29] Although litigation was brought against the auditors engaged in the audits of the Bernard L. Madoff Investment Securities feeder and sub-feeder funds,[30] none of the auditors to the feeder and sub-feeder funds have been held liable.[31]

Under federal law, public accounting firms are subject to liability for securities fraud under either the Securities Act of 1933 (the "1933 Act") or the Securities Exchange Act of 1934 (the "1934 Act"),[32] but only if the plaintiff investors have succeeded in meeting a high pre-trial threshold created by the heightened pleading requirement of the Private Securities Litigation Reform Act of 1995 ("PSLRA").[33] Therefore, between 1995 and 2002, the courts have developed a "federal common law"[34] standard to determine whether a public accounting firm may be subject to liability for securities fraud under the federal securities law.[35] Due to the limited professional oversight of the accounting profession and to the lack of judicial guidance by the U.S. Supreme Court,[36] the "common law" scienter standard developed by the federal courts was inconsistent and confusing.[37] However, Section 404 of the Sarbanes-Oxley Act considerably changes the nature of the duty of care required by public accounting firms in complying with their statutory obligations, because it provides a new mandate, according to which the auditor must "attest to, and report on, management's assessment of the company's internal control structure and procedures."[38] Therefore, since 2002, courts have struggled to reconcile the legal standard developed under the PSLRA heightened pleading

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28. SEC, 21274, Securities and Exchange Commission v. David F. Friehling, C.P.A and Friehling & Horowitz, CPA's, P.C. 1(S.D.N.Y. Civ. 09 CV 2467) 1 (2009), *available at* https://www.sec.gov/litigation/Litreleases/2009/lr21274.htm.

29. *Id.*

30. *See* Stephenson v PricewaterhouseCoopers, LLP, 482 Fed. Appx. 618 (2d. Cir. 2012), In re Merkin, 817 F. Supp. 2d 346 (S.D.N.Y. 2011), Saltz v First Frontier, L.P., 485 Fed. Appx. 461 (2d. Cir. 2012).

31. *Id.*

32. 15 U.S.C. §§ 77f, 78f (2012).

33. *See* 15 U.S.C. § 78u-4 (2012) (plaintiff has to state with particularity all relevant facts for each allegation and must show that these facts will give "rise to a strong inference that the defendant acted with the requisite state of mind").

34. *See* United States v. Northrop Corp., 59 F.3d 953, 958 (9th Cir. 1995) ("Even if federal common law otherwise would operate, it is displaced when Congress has decided the matter."); *see also* Edward A. Fallone, *Section 10(b) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach*, 1997 U. Ill. L. Rev. 71, 74(1997) (referring to "a kind of federal common law" (quotation marks omitted)).

35. *See infra* Section IV.

36. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194, 214 (1976).

37. *See infra* note 94.

38. *See supra* notes 8 and 25.

requirement and the certification requirements imposed by the Sarbanes-Oxley Act.[39]

Although federal circuit courts have pondered on the impact of a Sarbanes-Oxley certification securities fraud claims against insider defendants, the question of the Sarbanes-Oxley Section 404(b) certification's role on a securities fraud claim has not yet been incorporated by the federal judiciary in the assessment of the public accounting firm's liability.[40]

This article argues that the federal courts must modify the legal standard used to determine the scienter requirement in a Section 10(b) securities fraud claim against a public accounting firm,[41] because the Section 404(b) certification requirement, along with the jurisprudence of the enforcement agencies, such as the PCAOB or the SEC, can no longer be reconciled with the federal "common law" of scienter. Courts need to revise the scienter standard in order to reconcile the federal common law with the new guidance of the U.S. Supreme Court[42] and with the emerging standards developed by the PCAOB in its enforcement efforts.

Part II provides an overview of the evolution of the auditor's liability from the common law prior to the 1933 and 1934 Acts until the adoption of the PSLRA, as well as an overview of the federal common law rule developed by courts to analyze auditors' liability. Part III explains two significant changes to this environment, the Section 404(b) requirements and the new legal framework developed by the U.S. Supreme Court in *Tellabs v. Makor*.[43] Finally, Part IV explains why the courts must reconcile the legal standard applied to auditors under the Tellabs analysis, and provides guidance for a scienter analysis based on the case law already forming in the enforcement efforts of the PCAOB. In particular, federal courts will have to consider changing the "strong inference of scienter" test by incorporating the impact of additional inferences of knowledge based on the auditor certifications.

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39. *See* discussion *infra* Section III.
40. *See* discussion *infra* Section III.
41. *See infra* note 66.
42. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007).
43. *Id.*

II. HISTORY

A. Historical Background

The historical context for the liability of the external auditor[44] has its origins in a combination of contract law and tort law.[45] Under contract law, a plaintiff can recover only if he is able to prove that the accountant acted in an incompetent fashion, i.e. did not follow professional standards as defined by generally accepted accounting principles ("GAAP") or generally accepted accounting standards ("GAAS").[46] Under tort law, the plaintiff has to prove that the accountant acted fraudulently, i.e. that there was intent to defraud the client through misrepresentations in the audit.[47] Historically, the liability of auditors arising out of the review and certification of the financial representations of their clients slowly but progressively expanded.[48] Civil liability could be imposed against auditors either on the basis of fraud, which required an intent to deceive, combined with a reliance on the auditor's opinion, or on the basis of negligence, which involved a lesser degree of culpability.[49] The traditional "privity"[50] approach, still present within

44. PUB. CO. ACCOUNTING OVERSIGHT BD., RULE 1001(a)(xii) at 26, *available at* http://pcaobus.org/Rules/PCAOBRules/Documents/Section_1.pdf (defining auditor, which "means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof"), effective pursuant to Order Approving Proposed Rules Relating to Registration System, Exchange Release No. 34-50,331, Fed. Sec. L. Rep. (CCH) § 87,256 (Sept. 8, 2004), *available at* https://www.sec.gov/rules/pcaob/34-50331.htm. However, the PCAOB does not distinguish in Rule 1001 the external auditor is a common expression synonymous to the PCAOB defined term of "public accounting firm," Rule 1001 does not define the internal auditor, who usually designates employees of the issuer hired to assess and evaluate its system of internal control. To maintain independence, they usually present their reports directly to the Board of Directors or to top management. In addition, as internal auditors are employees of the issuer, they are assumed to be able to more easily find out the frauds and any accounting improprieties.

45. *See* DAN L. GOLDWASSER & M. THOMAS ARNOLD, ACCOUNTANTS' LIABILITY 1-2 to -8 (Larry D. Soderquist ed. 1996) (providing a detailed historical overview of the liability of accountants).

46. *See In re* Cardinal Health Sec. Litig., 426 F. Supp. 2d 688, 707 n.26 (S.D. Ohio 2006) (defining the GAAP standard as "the 'basic postulates and broad principles of accounting pertaining to business enterprises, approved by the Financial Accounting Standards Board of the American Institute of Certified Public Accountants (AICPA)'" and GAAS as the "standards prescribed by the Auditing Standards Board of the AICPA for the conduct of auditors in the performance of an examination"). The court went on to state that "[i]n the event there is no official pronouncement, the consensus of the accounting profession, as manifested in textbooks, for example, determines GAAP." *Id.*; *see also* AM. INST. OF CPAS, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*, AU § 9411 (2000), *available at* http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00411_9.pdf (providing guidance to auditors on GAAP); AM. INST. OF CPAS, *Consideration of Fraud in a Financial Statement Audit*, AU § 316.01 (2007), *available at* http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00316.pdf (disputing the presumption of validity in the case where no GAAP rule exists).

47. GOLDWASSER & ARNOLD, *supra* note 41, at 4-2 to -5.

48. Several authors have detailed the progression of the common law view of accountant liability. *See, e.g.*, Richard P. Swanson, *Theories of Liability*, *in* ACCOUNTANTS' LIABILITY: ALI-ABA COURSE OF STUDY MATERIALS 24, 26–52 (2008), *available at* http://files.ali-aba.org/free/coursematerials/cr008-course.pdf; Thomas L. Gossman, *The Fallacy of Expanding Accountant's Liability*, 1988 COLUM. BUS. L. REV. 213, 215 (1998).

49. *See* GOLDWASSER & ARNOLD, *supra* note 41, at 4-37, 4-55.

certain state jurisdictions, was to limit the auditor's liability for negligent misrepresentations or for intentional tortuous behavior only to its client or to third parties known to the auditor, where the third parties intended to receive and relied on the audit report.[51] The Restatement of torts approach extended the liability for loss suffered to any person or group of persons the auditor intended to supply the information or knew the recipient intended to supply it.[52] The so-called "California rule," adopted in *Rosenblum v. Adler*,[53] expanded the auditor's liability to any person whom the accountant could reasonably have foreseen would obtain and rely on the accountant's opinion, including known and unknown investors.[54]

Beyond their traditional common-law and state law obligations, and following the passage of the 1933 and 1934 Acts, external auditors had to follow a new federal mandate regarding audit engagements which involve corporations in which stock is traded on a U.S. national exchange and is subject to the periodic reporting requirements of the 1934 Act:[55] first, the external auditor must comply with the required procedures of audit performance, necessary investigation and disclosure to the Audit Committee.[56] This new requirement imbedded at the federal level the common-law notion that the auditor is obligated to investigate or disclose any

50. *See* Gossman, *supra* note 44, at 216 ("Privity is the connection that exists between parties to a contract. It is essential to the maintenance of a contract action that privity exist between the plaintiff and the defendant. It is clear that when an accountant and a client enter into a valid contract for the performance of an audit, the accountant and the client share a relationship of privity."); *see also* Swanson, *supra* note 44, at 27 (discussing the role of privity in accountants' liability).

51. *See generally* Ultramares Corp. v. Touche, 255 N.Y. 170 (1931); *see also* Swanson, *supra* note 44, at 26–27 ("In the seminal case of *Ultramares Corp. v. Touche*, New York's highest court, the Court of Appeals, held that persons damaged by their reliance on an accountant's negligently prepared financial statements who were not in privity with the accountant may not recover, unless they could show either (i) that the accountant defrauded them, or (ii) that the accountant actually knew they would rely on the financial statements."); Gossman, *supra* note 44, at 218 ("In substance, the *Ultramares* court set down the rule that an auditor will be liable for negligent misrepresentation only to its client and to any third parties whose identities are known to the auditor as parties intended to receive and rely on the audit report. It is significant that the *Ultramares* opinion still does not refer to the latter as parties in privity, but as persons with whom the bond is 'so close as to approach that of privity, if not completely one with it.' Although the intent is clear, perhaps it was yet too soon to chance clouding the issue of who should be permitted to sue for the breach of a contract with semantic questions of what is meant by 'privity.'").

52. *See* Restatement (Second) of Torts § 522 (1977) (extending professional liability beyond *Ultramares* to the known and intended class of beneficiaries. though limited to parties for whom reliance was actually foreseen by, rather than merely foreseeable to, the accountant.").

53. *See* Rosenblum, Inc. v. Adler, 93 N.J. 324, 352 (1983).

54. *See generally* Steven E. Stark, Rosenblum v. Adler*: Auditor's Liabiliy for Negligent Misrepresentation—"The Explosive Power Resident in Words*," 38 U. Miami L. Rev. 939 (1984) (reviewing in detail the changes brought by *Rosenblum v. Adler*).

55. A reporting issuer will be subject to the reporting requirements of the 1934 Act under one of three possible approaches: (1) Section 12(b) of the 1934 Act will cover any issuer of any class of securities listed on a National Securities Exchange; (2) Section 12(g)(1) will cover any entity with assets in excess of $10 Million, and with a class of equity securities held by at least 500 persons; (3) Section 15(d) will cover any entity which filed a Registration Statement under the 1933 Act, which then became effective. Securities Exchange Act of 1934, 15 U.S.C. §§ 78(a) to 78-4(e) (2012).

56. *See* 15 U.S.C. § 78j-1 (2012).

matter which may be material to the financial condition of its client,[57] because "it simply cannot be true that an accountant is under no duty to disclose what he knows when he has reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all the stockholders."[58] Second, since the passage of the Sarbanes-Oxley Act, the external auditor must attest to an internal controls report prepared by the issuer.[59]

Up until the passage of the Sarbanes-Oxley Act, the oversight of the accounting profession was very limited: The 1933 and 1934 Acts empowered the SEC to regulate the accounting standards used in the financial statements included in the SEC periodic requirements.[60] This authority was immediately delegated to the auditor's trade group, the American Institute of Accountants, later renamed the American Institute of Certified Public Accountants.[61] It is under this authority that the AICPA created the Auditing Standards Board (ASB) in 1978.[62] The ASB attempted to reinforce its oversight through the creation of the Public Oversight Board (POB) in 1977, however, its lack of sanctioning power and independence created enough political pressure for Congress to replace it by the PCAOB. It is the

57. *See* Richard F. Langan, Jr., *The Integrated Disclosure System, Registration and Periodic Reports Under the Securities and Exchange Act of 1934*, *in* TRANSACTIONAL LAWYER'S DESKBOOK: ADVISING BUSINESS ENTITIES (Arthur N. Field & Morton Moskin eds., 2001) (indicating that Item 8 of the 10K Form is where the auditor's report and all detailed audited financials must be located). For a thorough review of the history of the Auditor's report); *see also* Arthur Acevedo, *How Sarbanes-Oxley Should be Used to Expose the Secrets of Discretion, Judgment, and Materiality of the Auditor's Report*, 4 DEPAUL BUS. & COM. L.J. 1, 13 n.81 (2005) ("There are generally four different species of auditor's opinion contained within the standard auditor's report. The four variants are an unqualified opinion, a qualified opinion, a disclaimer opinion and an adverse opinion. The unqualified opinion is desired by all audit clients because it is perceived to be a bill of clean health. A full review of the reasons for and uses of the different opinions is beyond the scope of this work.").

58. United States v. Simon, 425 F.2d 796, 806 (2d Cir. 1969).

59. *See* 15 U.S.C. § 7262 (2012). For a general discussion of the impact of Section 404 on external auditors *see also* Tosha Huffman, *Section 404 of the Sarbanes-Oxley Act: Where the Knee Jerk Bruises Shareholders and Lifts the External Auditor*, 43 BRANDEIS L. J. 239, 253 (2004) ("[T]he external auditor must employ more tests of internal controls than what was previously utilized to develop an audit plan. The purpose for the increased internal control procedures is to allow the auditor to obtain a greater understanding of the operating effectiveness of the internal controls system. Such an understanding is necessary to express an opinion on the effectiveness of the internal controls and management's assessment of their effectiveness.").

60. *See supra* note 17.

61. *See History of the AICPA*, AM. INST. OF CPAS, www.aicpa.org/About/MissionandHistory/Pages/History of the AICPA.aspx (last visited Feb. 9, 2014) ("The American Institute of Certified Public Accountants (AICPA) and its predecessors have a history dating back to 1887, when the American Association of Public Accountants (AAPA) was formed. In 1916, the American Association was succeeded by the Institute of Public Accountants, when there was a membership of 1,150. The name was changed to the American Institute of Accountants in 1917 and remained so until 1957, when it changed to its current name of the American Institute of Certified Public Accountants. The American Society of Certified Public Accountants was formed in 1921 and acted as a federation of state societies. The Society was merged into the Institute in 1936 and, at that time, the Institute agreed to restrict its future members to CPAs.").

62. *Auditing, Attestation and Quality Control Standards Setting Activities: Operating Policies*, AM. INST. OF CPAS 1, http://www.aicpa.org/research/standards/auditattest/asb/downloadabledocuments/asb%20operating%20policies%20document%20(2009-10).pdf.

self-regulatory nature of the accounting profession which was cited as a contributing factor to the lack of detection of corporate fraud by auditors.[63]

Under the 1933 and 1934 Acts, the public accounting firm is subject to two significant risks of liability: First, under Section 11 of the 1933 Act,[64] all the plaintiff has to prove to impose liability against the public accounting firm which contributed to the development of the registration statement, is that the document contained a material misstatement or omission, and that the investors purchased the security under that registration statement.[65] The plaintiff need not prove any contractual relationship with the accountant, or prove any fraudulent intent by the external auditor or accountant who contributed to the registration process.[66] Unlike Section 11, under Section 10(b) of the 1934 Act, plaintiff must establish, amongst other elements, the fraudulent intent of the auditor.[67]

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63. *See* Donna M. Nagy, *Playing Peekaboo With Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 990 (2005) ("As Lynn Turner, former Chief Accountant at the SEC, testified [during the Accounting Reform and Investor Protection Issues Raised by Enron and Other Public Companies: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 107th Cong. 532 (2002)]: They actually draft the standards. One of the problems with that part of the system today is, when they go through that drafting process, since it is all being done by the firms themselves, in fact, their legal counsels get involved in editing those very standards themselves, those standards tend to be written to protect the accounting firms in case they get in trouble on an audit, sometimes probably which is deserved, and quite frankly, sometimes which is not deserved. . . . It is not drafted with the public interest in mind . . . . As long as you leave that standards setting process in the hands of the firms and of the firm's legal counsel, you are going to get standards written to protect them in court, as opposed to standards written to ensure that they do audits that will protect the public.").

64. *See* 15 U.S.C. § 77k (2012) (codifying Section 11 of the Securities Act).

65. *Id.* Under Section 11 of the 1933 Act, no scienter or reliance needs to be proven. However, Section 11 places the burden on the defendants to show their non-culpability regarding the issuance of the Registration Statement.

66. *See* Escott v. BarChris Construction Corp., 283 F. Supp. 643, 697–98 (S.D.N.Y. 1968) ("Section 11(b) provides: 'Notwithstanding the provisions of subsection (a) no person . . . shall be liable as provided therein who shall sustain the burden of proof— . . . (3) that . . . (B) as regards any part of the registration statement purporting to be made upon his authority as an expert . . . (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . .'"). Against the potential Section 11 liability, the external auditor will be entitled to assert a due diligence defense to defeat claims of negligence in discharging his responsibilities, whereas he will be subject to potential liability only for those portions of the registration statement they are responsible for preparing as experts.

67. *See* Robin v. Arthur Young & Co., 915 F.2d 1120, 1123 n.4 (7th Cir. 1990) (stating requirements for primary Rule 10b-5 claim as, "the defendant (1) made an untrue statement of material fact or omitted a material fact that rendered misleading the statements made (2) in connection with the purchase or sale of a security, (3) with the intent to mislead, and (4) which caused the plaintiff's loss." (citing Renovitch v. Kaufman, 905 F.2d 1040, 1045 n.7 (7th Cir. 1990))); Francine A. Ritter, *Accountability of the Independent Accountant As Auditor In the Wake Of Central Bank: Does the Implied Private Right of Action Survive Under Section 10(b) and Rule 10b-5?*, 31 SUFFOLK U. L. REV. 873, 891–92 (1998) ("[Following the Ernst & Ernst v. Hochfelder decision,] the Rule 10b-5 cause of action closely resembles a claim for common-law fraud. In order to set forth a successful private Rule 10b-5 claim, plaintiffs must prove that the defendant intentionally or knowingly engaged in manipulative or deceptive conduct, that the plaintiff relied on this conduct, and that the defendant's conduct proximately caused the plaintiff's injury."); *see also* cases cited *infra* note 90.

B. Section 10(b) Liability

Under the 1933 and 1934 Acts, enacted in response to widespread abuses in the securities markets perceived to contribute to the market crash of 1929, Section 10(b) and Rule 10b-5, promulgated by the SEC, are general anti-fraud provisions which prohibit any person from using or employing any manipulative or deceptive device in connection with the purchase or sale of any security.[68] The jurisprudence from federal courts recognized an implied private right of action under Rule 10b-5,[69] but also imposed a number of requirements, most notably a deception in connection with the securities transaction,[70] the use of jurisdictional means,[71] and a requirement that plaintiffs must have standing as actual purchasers and sellers of securities.[72] For a Section 10(b)/Rule 10b-5 cause of action to be successful, plaintiff must assert that the deception involved material information,[73] that defendant acted

68. 15 U.S.C. § 78j(b) (2012); 17 C.F.R. § 240.10b-5 (1997).

69. Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971); Ritter, *supra* note 63, at 890–91 ("While conceding that a strict statutory interpretation of Section 10(b) provides no express private remedy, since 1946 federal courts have consistently recognized implied private rights of action under both Section 10(b) and Rule 10b-5. In permitting private recovery under Section 10(b) and Rule 10b-5, lower federal courts have analogized the principles of tort law to the 1934 Act's broad remedial purpose of protecting investors. The Supreme Court of the United States has bolstered this liberal interpretation of Section 10(b) by asserting that private recovery comports with the 1934 Act's underlying policy objective of protecting investors through the use of full and fair disclosure. Since defrauded purchasers and sellers of securities have attained standing to sue under Section 10(b) and Rule 10b-5, violators of these provisions have faced expanded liability.").

70. *See* SEC v. Zandford, 535 U.S. 813, 819, 822 (2002) (holding that misstatements may be actionable as a breach of fiduciary duty and as fraud in connection with securities transactions) ("[T]he SEC has consistently adopted a broad reading of the phrase 'in connection with the purchase or sale of any security' . . . . [Accordingly, i]t is enough that the scheme to defraud and the sale of securities coincide.").

71. I.e. the use of instrumentality of interstate commerce, such as mails, or a national securities exchange.

72. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737–38 (1975) (recognizing that the Birnbaum rule bars three potential classes of plaintiffs: first there are "potential purchasers of shares . . . who allege that they decided not to purchase because of an unduly gloomy representation or the omission of favorable material which made the issuer appear to be a less favorable investment vehicle than it actually was. Second are actual shareholders in the issuer who allege that they decided not to sell their shares because of an unduly rosy representationFalse Third are shareholders, creditors, and perhaps others related to an issuer who suffered loss in the value of their investment due to corporate or insider activities in connection with the purchase or sale of securities which violate Rule 10b-5.").

73. *See* Basic Inc. v. Levinson, 485 U.S. 224, 236 (1987) (endorsing the standard of materiality for Section 10(b) causes of action from *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), whereby an omitted fact is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available).

with scienter,[74] that plaintiff relied on the misrepresentation or deception,[75] which caused plaintiff's financial injuries that can be translated in measurable damages.

Therefore, the critical element a plaintiff must satisfy to establish a cause of action under federal law is the scienter requirement, whereby the plaintiff must prove that the auditor acted with either intent to defraud or was sufficiently reckless in the performance of its audit that it consisted a conscious disregard of its professional and statutory obligations.[76]

In the context of claims against auditors, Section 10(b) can represent a significant risk of liability to accountants and other professionals involved in securities transactions. Since the U.S. Supreme Court decided *Ersnt & Ernst v. Hochfelder*, the fundamental challenge to a plaintiff in a Section 10(b) action was to prove scienter.[77]

Given the specific mandate of the public accounting firm, how would courts apply the scienter concept to an auditor? In *Ernst & Ernst v. Hochfelder*, the Supreme Court defined scienter as an "intent to deceive, manipulate, or defraud,"[78] but also indicated it was willing to extend the concept of scienter to two other possible views, one focused on the requirement of "actual knowledge of misstatements, irrespective of intent,"[79] and another view focused on manifest reckless conduct, which "is considered to be a form of intentional conduct for purposes of imposing liability for some act."[80] This wide spectrum of potential interpretations left little guidance for both the plaintiffs and the defendants, as well

74. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). ("Although the verbal formulations of the standard to be applied have varied, several Courts of Appeals have held in substance that negligence alone is sufficient for civil liability under § 10(b) and Rule 10b-5 (internal citations omitted). Other Courts of Appeals have held that some type of scienter - i.e., intent to defraud, reckless disregard for the truth, or knowing use of some practice to defraud - is necessary in such an action (internal citations omitted). In this opinion the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.").

75. *See* AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 209 (2d Cir. 2000) (distinguishing transaction causation, where the misrepresentations caused the plaintiff to engage in a transaction, from loss causation, which requires a finding that the unlawful conduct was the proximate cause of the economic harm).

76. *See In re* WorldCom, Inc. Sec. Litig., 2003 U.S. Dist. LEXIS 10863, at *17 (S.D.N.Y. June 24, 2003) ("The requisite state of mind, or scienter, in an action under section 10(b) and Rule 10b-5, that the plaintiff must allege is an intent to deceive, manipulate or defraud." (quoting Kalnit v. Eichler, 264 F.3d 131, 138 (2d Cir. 2001))).

77. *See Ernst & Ernst*, 425 U.S. at 201 ("[Section] 10 (b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone.").

78. *Id.* at 193.

79. *Id.* at 197; *see* Elaine E. Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10B-5:* Ernst & Ernst v. Hochfelder, 29 Stan. L. Rev. 213, 219 n.31 (1977) (explaining that the existing jurisprudence recognizes that the language of Section 10(b) covers both knowing or intentional misconduct, i.e. that knowledge of the misconduct was sufficient to establish scienter).

80. *Ernst & Ernst*, 425 U.S. at 194 n.12.

as for federal courts.[81] This lack of guidance generated significant differences and circuit splits, which were compounded by the passage of the Private Securities Litigation Reform Act of 1995 ("PSLRA").[82]

C. The Impact of the PSLRA

It is the pleading requirement of the PSLRA applied to the intent element which has created much controversy and has become the critical factor used by courts to dismiss cases early in the litigation process as it relates to auditors.[83] Following a perceived increase of frivolous securities fraud suits aimed at extracting quick settlements using Section 10(b)-based claims, Congress passed the PSLRA to ensure that the heavy burden of discovery processes under federal securities law against corporations and their external auditors would be limited.[84] The main procedural tool designed by Congress to correct this perceived inequity was to create a significant exception to the liberal notice-pleading doctrine of the Federal Rules of Civil Procedure by imposing heightened pleading requirements for securities fraud

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81. *See* Bucklo, *supra* note 80, at 226–27 ("Although the Supreme Court initially attempted to define scienter in concrete, categorical terms, an analysis of its subsequent language reveals considerable confusion as to the degree of culpability that the Court intended to require a plaintiff seeking damages under rule 10b-5 to plead and prove. In fact, the Court's opinion in *Ernst & Ernst* is susceptible of being read to support any of three definitions of scienter—intent, knowledge or recklessness. The Court's analysis of Section 10(b)'s language, history and especially its interdependence with other federal securities provisions indicates that it clearly would include intentional misrepresentation and almost certainly knowledge in its definition of scienter, leaving the sufficiency of recklessness in question. On the recklessness question, the opinion provided enough support for both sides of the issue to justify taking the Court at its word as to the openness of that issue.").

82. *See* discussion *infra* note 84.

83. Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097, 1101 (2007).

84. *See* Kevin P. Roddy, *Nine Years of Practice and Procedure Under the Private Securities Litigation Reform Act of 1995*, *in* POSTGRADUATE COURSE IN FEDERAL SECURITIES LAW: ALI-ABA COURSE OF STUDY MATERIALS 749, 756, *available at* Westlaw SL020 ALI-ABA 749, 756 (2005) ("The Private Securities Litigation Reform Act of 1995 ("PSLRA") was enacted by Congress on December 22, 1995 over President Clinton's veto. Several district courts have stated that the PSLRA was intended 'to combat the filing of abusive and meritless lawsuits.' (quoting Carson v. Merrill Lynch, Pierce, Fenner & Smith, 1998 U.S. Dist. LEXIS 6903, at *10 (W.D. Ark. Mar. 30, 1998))); *see also* David S. Escoffery, *A Winning Approach To Loss Causation Under Rule 10b-5 In Light of the Private Securities Litigation Reform Act of 1995*, 68 FORDHAM L. REV. 1781, 1810–1813 (2000) (explaining in the legislative history of the PSLRA, the lobbying role of the public accounting firms and the committee negotiation process in both houses of Congress); Charles M. Yablon, *A Dangerous Supplement? Longshot Claims and Private Securities Litigation*, 94 NW. U. L. REV. 567, 572 (2000) (arguing that the PSLRA discourages valid fraud claims from being brought); *see generally* Sanford P. Dumain, *Accountants' Liability, Class Action Suits, Auditor Liability, and the Effect of the Private Securities Litigation Reform Act of 1995*, *in* ACCOUNTANTS' LIABILITY: ALI-ABA COURSE OF STUDY MATERIALS 205 (2006), *available at* Westlaw SL064 ALI-ABA 205.

claims.[85] To successfully bring a Section 10(b) action, a plaintiff must allege: "(1) a misleading statement or omission of a material fact; (2) made in connection with the purchase or sale of securities; (3) with intent to defraud or recklessness; (4) reliance; and (5) damages."[86] It is the pleading of the intent element which has created much controversy and has become the critical factor used by courts to dismiss cases early in the litigation process.[87] To survive a motion to dismiss, a plaintiff must allege with particularity sufficient facts, which will allow the court to establish a "strong inference" of scienter.[88] Under the PSLRA pleading requirement, which forces the plaintiff to make particular factual allegations, a court will grant the motion to dismiss if the allegations in the complaint are general or "conclusory in nature."[89] Under the U.S. Supreme Court jurisprudence,[90] the basic requirement used to evaluate the state of mind of external auditors is that plaintiffs must prove "that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments made were such that no reasonable accountant would have made the same decisions if confronted with the same facts."[91] Similarly, at the pleading stage, plaintiffs, to allege scienter, must include in the complaint specific facts showing that the audit deficiencies were "so severe that they strongly suggest that the auditor must have been aware of the corporation's fraud."[92] This heightened pleading requirement has been recognized to be a strong barrier to securities fraud claims involving external auditors,[93] and the federal jurisprudence in all circuits has shown that it has become more difficult to plead scienter against external auditors than against corporate insiders, and that the threshold against an

85. *See* 15 U.S.C. § 78u-4(b)(1) (2012) ("the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed"); 15 U.S.C. § 78u-4(b)(2) (2012) ("the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.").

86. Grossman v. Novell, Inc., 120 F.3d 1112, 1118 (10th Cir. 1997).

87. Gideon, *supra* note 79.

88. *In re* Cardinal Health Inc. Sec. Litig., 426 F. Supp. 2d 688, 717–18 (S.D. Ohio 2006).

89. *Id.* at 737.

90. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

91. PR Diamonds Inc. v. Chandler, 364 F.3d 671, 693–94 (6th Cir. 2004) (quoting *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1426 (9th Cir. 1994)).

92. *Cardinal Health,* 426 F. Supp. 2d at 764 (citing *PR Diamonds Inc.,* 364 F.3d at 694)).

93. *See* Edward P. Leibensperger & Lauren M. Papenhausen, *Auditor Liability For Securities Fraud After the PSLRA and Sarbanes-Oxley*, 28 ALI-ABA Bus. L. Course Materials J. 15, 18 (2004) ("The heightened pleading requirement of the Reform Act is particularly difficult to meet in cases brought against auditors. A developing line of Reform Act cases recognizes that it is more difficult to plead scienter with respect to independent auditors than to corporate insiders. Courts have often dismissed securities fraud complaints against auditors even where the complaints have adequately pled claims alleging accounting improprieties against the auditors' client.").

external auditor is higher than for the insider defendant, making it more difficult to plead scienter against external auditors than against corporate insiders.[94]

Because the PSLRA did not precisely define the required state of mind or provide a standard as to whether a strong inference of that state of mind has been pled adequately, various circuit courts have differed in their application of the PSLRA's scienter pleading requirements.[95] While the Second and Third Circuits found that circumstantial evidence of the defendant's "motive and opportunity" were sufficient to properly infer scienter, the Ninth Circuit rejected this "motive and opportunity" test and adopted a conservative reading of the *Ernst & Ernst v. Hochfelder* view of intent, by requiring that plaintiffs "must state facts that come closer to demonstrating intent, as opposed to mere motive and opportunity."[96]

Between these two extreme views across the possible interpretations of the Supreme Court's scienter standard, the Sixth Circuit endorsed the "recklessness-only" view of *Ernst & Ernst v. Hochfelder*. Although the Sixth Circuit rejected the "motive and opportunity" test by holding that "the bare pleading of motive and opportunity does not, standing alone, constitute the pleading of a strong inference of scienter,"[97] a plaintiff may establish scienter by alleging recklessness, defined as "highly unreasonable conduct" representing "an extreme departure from the standards of ordinary care," which is akin to "conscious disregard."[98] The threshold analysis required by the Sixth Circuit "differs from the Ninth Circuit in that it has left open the possibility that detailed allegations of motive and opportunity might be sufficient if they 'simultaneously establish that the defendant acted recklessly or knowingly, or with the requisite state of mind.'"[99] To attempt to apply these various approaches objectively, the various federal circuits established a number of different

94. *Id.* ("Courts have found that auditors warrant different treatment from corporate insiders for purposes of pleading scienter because they have less to gain (in terms of stock options or fees) and more to lose (in terms of their professional reputation) than do corporate insiders.").

95. *See generally* Cadwalader, Wickersham & Taft LLP, *Split Widens on Scienter Pleading Standard Under the PSLRA*, FINDLAW.COM (Mar. 26, 2008), http://library.findlaw.com/1999/Se p/1/127316.html (summarizing each circuit's handling of the scienter requirement).

96. *In re* Silicon Graphics Sec. Litig., 183 F.3d 970, 974 (9th Cir. 1999) (holding that the PSLRA requires plaintiff to plead "deliberately reckless or conscious misconduct").

97. *In re* Comshare Inc. Sec. Litig., 183 F.3d 542, 551 (6th Cir. 1999).

98. *See id.* at 550; *see also* Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1025 (6th Cir. 1979). Although there are some similarities between the Sixth Circuit's approach and the standard adopted by the Ninth Circuit, the Sixth Circuit has not gone so far as to require a securities fraud plaintiff to allege "deliberate recklessness."

99. Robert W. Perrin, Brian T. Glennon & Julie R.F. Gerchik, *The State of Scienter: A Comparative Survey Ten Years After the Enactment of the Private Securities Litigation Reform Act*, LEGALWORKS, Dec.-Jan. 2006, at 4 (quoting Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 (6th Cir. 1979)). *See* Christopher M. Fairman, *Heightened Pleading*, 81 TEX. L. REV. 551, 606–07 (2002); *see also* Dumain, *supra* note 80, at 221 ("The Sixth Circuit has taken a middle course, holding that scienter could be alleged by pleading facts that give rise to a strong inference of recklessness, but refusing to accept the proposition that allegations of motive and opportunity to commit fraud were sufficient to plead scienter, unless the facts demonstrate the required state of mind, namely that the defendant acted recklessly or knowingly.").

approaches: While the Second and Third Circuits focused on an analysis of the motive and opportunity of defendants, the Sixth Circuit relied on the so-called "*Helwig*" factors, first identified in *Helwig v. Vencor, Inc.*,[100] which enumerates objective factors used to establish scienter in securities fraud actions.[101]

Another example of the confusion between the circuits is the type of facts required in a PSLRA pleading. For instance, a recurring question is whether significant violations of GAAP and GAAS principles are sufficient on their own to establish a strong inference of scienter on the part of the outside auditor. In most circuits, it has been well-established that alleging a violation of GAAP or GAAS is not sufficient, by itself, to establish a strong inference of scienter on the part of an outside auditor, even if the auditor is grossly negligent in carrying out its responsibilities.[102] Rather, courts usually require additional evidence of intent or recklessness, such as facts placing a reasonable auditor on notice of wrongdoing, which the auditor chose to ignore, usually called "red flags."[103] However, it is clear that the circuit split regarding the facts necessary to establish scienter under the PSLRA shows that no consensus exists as to the level of recklessness required to reach a minimum threshold necessary to fall within the *Ernst & Ernst* standard.[104]

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100. *Helwig v. Vencor, Inc.*, 251 F.3d 540, 552 (6th Cir. 2001) (en banc), *abrogated by* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 323–24 (2007).

101. *Id.* (establishing the "*Helwig*" factors as: "(1) insider trading at a suspicious time or in an unusual amount; (2) divergence between internal reports and external statements on the same subject; (3) closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information; (4) evidence of bribery by a top company official; (5) existence of an ancillary lawsuit charging fraud by a company and the company's quick settlement of that suit; (6) disregard of the most current factual information before making statements; (7) disclosure of accounting information in such a way that its negative implications could only be understood by someone with a high degree of sophistication; (8) the personal interest of certain directors in not informing disinterested directors of an impending sale of stock; and (9) the self-interested motivation of defendants in the form of saving their salaries or jobs"). The reason *Helwig* is often cited is that it is the only case that attempts to define specific objective factors in the scienter analysis rather than subjective criteria such as an auditor's motives.

102. *See* Chill v. Gen. Elec. Co., 101 F.3d 263, 270 (2d Cir. 1996) ("Allegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent, are not sufficient to state a securities fraud claim."); *see also* Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994) ("boilerplate averments that the accountants violated particular accounting standards are not, without more, sufficient to support inferences of fraud"); Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 120 (2d Cir. 1982) (holding that allegations concerning violations of general accounting principles were insufficient to properly plead securities fraud in conformance with Rule 9(b)); Cheney v. Cyberguard Corp., No. 98-6879-CIV-GOLD, 2000 WL 1140306, at *11 (S.D. Fla. July 31, 2000) ("Courts uniformly hold that allegations of GAAP and GAAS violations are insufficient, without more, to state a securities fraud claim."); Greebel v. FTP Software, Inc., 182 F.R.D. 370, 375 (D. Mass. 1998) (scienter cannot be established by "generalized allegations of violations"). Indeed, GAAP or GAAS violations may show that an auditor or accountant was grossly negligent, however, without more, there cannot be a strong inference of scienter. *See* Reiger v. Altris Software, No. 98-CV-528-TW-JFS, 1999 WL 540893, at *7 (S.D. Cal. April 30. 1999) ("[A]llegations that an accountant or auditor conducted an inadequate audit by violating accounting or auditing principles do not, without more, adequately plead a strong inference of scienter.").

103. *See In re* Telxon Corp. Sec. Litig., 133 F. Supp. 2d 1010, 1026, 1030, 1033 (N.D. Ohio 2000); *see also infra* note 221and accompanying text (defining "red flag").

104. *See* Bucklo, *supra* note 80, at 226.

The PLSRA introduced several other requirements, both substantive and procedural, designed to prevent frivolous lawsuits from being filed, which have a significant impact on claims against public accounting firms.[105] On the substantive side, the PSLRA replaced the joint and several liability under recklessness or negligence claims with proportionate liability.[106] Procedurally, the main change impacting claims against auditors are the appointment of a lead plaintiff[107] and a required stay of discovery, where the discovery is stayed during the pendency of a motion to dismiss.[108] Additionally, the PSLRA codifies standards providing that financial statement audits required under the securities laws must include procedures designed to provide a reasonable assurance of detecting material illegal acts. This codification describes how the auditor, upon the discovery of illegal acts, must inform the issuer's management, and if an illegal act is determined to have a material effect on the financial statements, and if senior management fails to take appropriate remedial actions, how the auditor must report to the board of directors and to the SEC.[109] These new provisions and associated SEC rules did show that Congress, even before the Sarbanes-Oxley Act, identified an increased affirmative disclosure obligations of the auditor to the entity and the SEC regarding material misrepresentations imbedded in the financial statements.

105. Dumain, *supra* note 80, at 210.

106. The PSLRA imposes several other substantive changes, including heightened pleading requirements for material misrepresentations and for the defendant's state of mind, 15 U.S.C. § 78u-4(b)(1) to (2) (2012), specific calculation rules for the measure of damages based on objectively measured stock price points, 15 U.S.C. § 77z-1(b)(4) (2012), the codification of the loss causation rule, 15 U.S.C. § 78u-4(b)(4) (2012), an enhancement to the safe-harbor protection for forward-looking statements by issuers, 15 U.S.C. §§ 77z-2, 78u-5 (2012), and the preserving of aiding and abetting claims by the SEC under section 10(b), 15 U.S.C. § 78u-3 (2012). For proportionate liability, the PSLRA replaces traditional joint and several liability by proportionate liability for claims based on "non-knowing" conduct against outside directors under Section 11 of the 1933 Act and against all persons for claims under the 1934 Act, 15 U.S.C. § 78u-4(g) (2012).

107. Within 90 days of publication of the notice, the court appoints a lead plaintiff from among those who have filed a complaint or moved to serve as lead plaintiff, usually the person(s) having the largest financial interest in the case. 15 U.S.C. §§ 77z-1(a)(3), 78u-4(a)(3) (2012).

108. *See* 15 U.S.C. §§ 77z-1(b), 78u-4(b) (2012) ("In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party."); *see also* Brian Philip Murray, *Lifting the PSLRA "Automatic Stay" Of Discovery*, 80 N.D. L. REV. 405, 405 (2004) (suggesting that the automatic stay rule may not have the destructive effect the plaintiff's bar claimed the rule had on valid suits because courts increasingly lift the stay).

109. Section 301 of the PSLRA added new Section 10A to the 1934 Act, which requires auditors to adopt procedures that will give reasonable assurance of detecting illegal acts and that will identify related-party transactions. The SEC has adopted rules, effective April 17, 1997, to implement Section 10A. *See* Implementation of Section 10A of the Securities Exchange Act of 1934, SEC Release No. 34-38387, 62 Fed. Reg. 12,743, 12,748 (Mar. 12, 1997) (codified at 17 C.F.R. pts. 210, 240 (2011).

D. Primary Liability for Secondary Actors under Section 10(b)

Public accounting firms may only face liability for securities fraud in a Section 10(b) claim if the plaintiff successfully pleads that the auditor was a primary perpetrator of securities fraud.[110] In *Central Bank of Denver v. First Interstate Bank of Denver*,[111] the U.S. Supreme Court held that the federal securities laws impose liability only on primary perpetrators of securities fraud, and do not create liability against secondary actors, who usually are bankers, auditors, or attorneys, for aiding and abetting primary violations.[112] Therefore, claims, which would only describe an auditor conspiring to assist a corporate insider to defraud investors, would not face liability under Section 10(b).[113]

Although distinguishing between a primary actor and a secondary actor can be difficult, most courts agree that while the primary violator is the one who violates a prohibited act set forth by the statute, the secondary violator, although not performing the prohibited act, has responsibility for it if he or she assists or has a relationship with the primary violator.[114] Another circuit split emerged as to how to determine whether an auditor, usually held to be a secondary actor, can be held liable under Section 10(b) under one of two primary liability theories. Some courts followed the lead of the Ninth Circuit by applying a "substantial participation" or "intricate involvement" standards, where an auditor may be held liable under Section 10(b) if the auditor was "substantially involved" in the misrepresentations or omissions in the financial statements which supported the fraud.[115] Other courts,

110. *See* Anixter v. Home-Stake Production Co., 77 F.3d 1215, 1224 n.8 (10th. Cir. 1996) ("therefore, aiding and abetting a § 10(b) violation cannot be the basis of liability in private actions still before the courts" (citing James B. Beam Distilling Co. v. Georgia, 501 U.S. 529, 544 (1991))). "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." *Id.* at 1224.

111. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191–92 (1994).

112. *Id.* at 191.

113. *See* Mary M. Wynne, *Primary Liability Amongst Secondary Actors: Why The Second Circuit's "Bright Line" Standard Should Prevail*, 44 ST. LOUIS U. L.J. 1607, 1611–12 (2000); *see generally* William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws-Aiding and Abetting Conspiracy, Controlling Person, and Agency: Common-Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313 (1989) (defining conspiracy liability and providing background information on the issue).

114. *See supra* note 106 and accompanying text.

115. *See* Wynne, *supra* note 109, at 1613–14. For authority on "substantial participation," see, for example, *In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 628 n.3 (9th Cir. 1994) (holding an accounting firm's substantial participation in drafting and editing misleading letters to the SEC was sufficient to support claim of primary liability); Adam v. Silicon Valley Bancshares, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995) (holding that plaintiffs could allege primary liability against accountant based upon various statements and reports issued by company); Cashman v. Coopers & Lybrand, 877 F. Supp. 425, 433 (N.D. Ill. 1995) (holding that primary liability can be based on accounting firm's central role in drafting misleading statements); *In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 970 (C.D. Cal. 1994) (holding that an auditor may be primarily liable for securities fraud even if false statements could not be reasonably attributed to it).

following the Second Circuit, developed a more restrictive approach, by applying a so-called "bright line" standard, whereby liability for secondary actors, like auditors, will only be found when the defendant actually made a fraudulent misstatement or omission and such a misstatement or omission can be attributed to them.[116] Yet the Second Circuit developed a third approach by considering the auditor as a primary actor in a Section 10(b) claim, and by holding that the auditor has a duty to correct its certified opinion. In *Overton v. Todman*,[117] the Second Circuit, by expanding the duty owed by auditors in their certification to all shareholders who rely on their opinion, is essentially transforming the auditor into a primary actor of a potential fraud or misrepresentation.

In *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*,[118] the U.S. Supreme Court cited and reaffirmed its decision in *Central Bank.*[119] The court reaffirmed that there is no private right of action for aiding and abetting a Section 10(b) violation.[120] The Court notes that the decision in *Central Bank* led to calls for Congress to create an express cause of action for aiding and abetting, but even though then-SEC Chairman Arthur Levitt recommended that aiding and abetting liability in private claims be established, Congress did not follow this course.[121] Section 10(b) right of action does not extend to aiders and abettors, unless the conduct of the secondary actor satisfies each of the elements or preconditions for liability.[122]

Therefore, for Section 10(b) claims against auditors, plaintiffs still have to defeat the heightened pleading requirement created by the Private Securities Litigation Reform Act of 1995,[123] have to plead primary violations, and have to defeat a number of evidentiary challenges when using financial information audited by the public accounting firm.

116. *See In re* MTC Elec. Techs. S'holders Litig., 898 F. Supp. 974, 987 (E.D.N.Y. 1995) ("[I]f *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)."); *see also* Wright v. Ernst & Young, 152 F.3d 169, 175 (2d Cir. 1998) ("[A] secondary actor cannot incur primary liability under the Act for a statement not attributed to the actor.").

117. 478 F.3d 479 (2d Cir. 2007).

118. 128 S.Ct. 761 (2008).

119. *See id.* at 768.

120. *Id.* at 767.

121. *Id.* at 768-9; S. Hearing No. 103-759, pp. 13-14(1994).

122. *Id.* at 769. The plaintiff must prove the following elements or preconditions to extend liability to secondary actors:"(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Id.* at 768.

123. *See* 15 U.S.C. § 78u-4 (2012).

E. How should the scienter analysis be applied to the facts pled?

Section 404(b) of the Sarbanes-Oxley Act of 2002 provides that the auditor must "attest to, and report on, management's assessment of the company's internal control structure and procedures."[124] Therefore, since 2002, courts struggled with reconciling the increase in liability due to the failure in the new certification obligations and the PSLRA heightened pleading requirement language.

The approach towards analyzing the pleaded facts individually or collectively is critical in ensuring that the proper legal standard is applied to a claim. Prior to the passage of the PSLRA, plaintiffs in securities fraud claims attempted to satisfy their burden of pleading scienter by "alleging that a series of concededly true statements, taken together, or as a 'mosaic,' gave a false impression to the market as a result of alleged omissions."[125] However, the PSLRA has been interpreted as rejecting this approach, because the statutory language states, "each statement alleged to have been misleading." The wording was thought to require that the heightened pleading requirement as well as the strong inference of scienter would be driven by each allegation or statement on its own.[126] Consequently, the so-called "mosaic theory" was thought to be rejected by Congress.[127] However, this view was premature. A number of decisions across the country demonstrate that the courts are showing a renewed interest in the approach.

The mosaic theory concept first made a comeback in the judicial review of the materiality element in Section 10(b) claims where "each individual piece of information at issue must be evaluated in the context of the overall impression created by the statements as a whole."[128]

Courts then extended their renewed interest with the mosaic theory approach to the scienter pleading requirement analysis. In *Broudo v. Dura Pharm., Inc.*,[129] although the U.S. Court of Appeals for the Ninth Circuit upheld the finding that scienter was insufficiently pleaded as to individual statements, the court observed that, "[w]hile the district court did a detailed analysis of the Appellants' separate arguments for scienter," the "allegations of scienter must be collectively considered," whereby, "[b]eyond each individual allegation we also consider 'whether *the total of plaintiffs' allegations*, even though individually lacking, are sufficient to create a strong inference that defendants acted with deliberate or

124. 15 U.S.C. § 7262 (2007).

125. Richard L. Jacobson & Joshua R. Martin, *The Private Securities Litigation Reform Act of 1995: A Survey of the First Three Years*, in SECURITIES LITIGATION: PLANNING AND STRATEGIES: A.L.I.-A.B.A. COURSE OF STUDY MATERIALS 861, 865 (1999).

126. *See* 15 U.S.C. §§ 78u-4(b)(1), 78u-4(b)(2) (2012).

127. The term "mosaic theory" is a generic term used in many unrelated fields but in the US legal context, "mosaic theory" is used synonymously with the "totality of the circumstances" test.

128. Phillip Wesley Lambert, *Worlds Are Colliding: A Critique of the Need for the Additional Criminal Securities Fraud Section in Sarbanes-Oxley*, 53 CASE W. RES. L. REV. 839, 848 (2003).

129. 339 F.3d 933 (9th Cir. 2003).

conscious recklessness."[130] Because the trial court did not apply the "totality of the allegations" test, the Court of Appeals remanded the case.[131] Again, the mosaic theory proved critical in the Eleventh Circuit *Lattice* decision,[132] where the District Court denied defendants' motion to dismiss a securities fraud class action. The *Lattice* court concluded that plaintiffs as a whole raised a strong inference that defendants acted with scienter because even though GAAP violations considered individually were not necessarily indicative of scienter, the significance of them, along with a long list of other specific claims,[133] when viewed in the totality of the allegations added additional weight to the inference of scienter.

Similarly, in *In re Rent-Way Securities Litigation,*[134] the court found that plaintiffs' allegations against the external auditor, Pricewaterhouse Coopers (PwC), supported an inference of scienter because all the allegations put together collectively gave rise to a strong inference of recklessness at least.[135] Plaintiffs claimed that PwC's scienter could be inferred from the magnitude and duration of the fraud, which had a considerable impact on the stock price, PwC's "serial violations" of GAAP and GAAS,[136] PwC's knowledge that Rent-Way's internal accounting structure and controls were inadequate,[137] and PwC's disregard for a number of "red flags."[138] The *Rent-Way* court noted that none of the individual allegations, standing alone, would be sufficient to satisfy the scienter requirement, however, when combined with "red flags," the allegations here satisfied the pleading standard of the PSLRA,[139] and the court concluded that the allegations supported a strong inference of scienter.[140]

The re-emergence of the mosaic theory in the application of the PSLRA heightened pleading requirement has a significant impact on how to weigh a Section 404(b) certification in the scienter analysis. Federal courts will no longer be able to analyze a Section 404(b) certification in isolation and conclude whether the

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130. *Id.* at 940 (quoting No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 938 (9th Cir. 2003)).

131. *Id*. at 940–41.

132. *In re* Lattice Semiconductor Corp. Sec. Litig., No. CV04-1255-AA, 2006 WL 538756, at *19 (D. Or. Jan. 3, 2006).

133. *Id*. at *19–20 (noting that the additional allegations included the design and operation of the company's internal controls, which were the subject of the Sarbanes-Oxley certifications, the defendants' alleged motive to inflate the company stock to avoid a goodwill write-off, the desire to keep newly issued options "above water," and to maximize executives bonuses).

134. 209 F. Supp. 2d 493 (W.D. Pa. 2002).

135. *Id.* at 511.

136. *Id*. at 506.

137. *Id.* at 508.

138. *Id.* at 508–509 (noting that the specific allegations include Rent-Way's weak internal accounting controls, improperly functioning software systems, manually adjusted general ledger entries, and declining expense ratios during a period of growth).

139. *Id.*

140. *Id.* at 507, 509, 511.

certification is a stand-alone "silver bullet,"[141] but rather will have to draw the appropriate inferences from the certification and analyze this inference collectively with other inferences drawn from other parts of the complaint. This approach was effectively endorsed by the U.S. Supreme Court in *Tellabs v. Makor*.[142]

F. A partial resolution of the scienter analysis circuit split: Tellabs v. Makor

On June 21, 2007, the U.S. Supreme Court provided decisive guidance in resolving the circuit split which had developed since 1995 regarding the proper analysis of the scienter requirement in a Section 10(b) claim.[143] In *Tellabs*, the U.S. Supreme Court developed a framework for federal courts to evaluate whether a plaintiff did "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[144] By vacating the opinion of the Seventh Circuit Court of Appeals, Justice Ginsburg rejected the notion that strong inference was met if the particularized facts could lead a "reasonable man" to infer that the defendant acted with the required intent, which was a lower threshold than the "most plausible of competing inferences" standard advocated by the Sixth and Second circuits.[145] The *Tellabs* decision provides several directions which are critical to the auditor's liability risk in the context of a Section 404(b) certification.

First, the *Tellabs* decision seems to provide a framework for scienter analysis for both insiders and secondary actors, such as auditors. There is no attempt by the court to differentiate the analysis based on the type of defendants, which has been a consistent approach by the U.S. Supreme Court every time the issue of scienter has been reviewed.[146] Therefore, the *Tellabs* approach will become the framework for future cases involving auditor liability under Section 10(b).

Second, the *Tellabs* court provides its understanding of the strong inference of scienter requirement, by confirming that courts should only be looking indicia of "strong" or "powerful or cogent" inferences, meaning "'[p]owerful to demonstrate or convince."[147] Therefore, the *Tellabs* court abandoned the notion that the PSLRA

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141. *See* MERRIAM WEBSTER'S COLLEGIATE DICTIONARY 1093 (10th ed. 1993) ("silver bullet: Something that acts as a magical weapon; *esp* one that instantly solves a long-standing problem").

142. 551 U.S. 308 (2007).

143. *Id*. at 319–20, 322–23.

144. 15 U.S.C. § 78u-4(b)(2) (2012).

145. Fidel v. Farley, 392 F.3d 220 (6th Cir. 2004).

146. The only three cases where the scienter element in Section 10(b) claims was part of the central holding are Tellabs v. Makor, 551 U.S. 308, 322– 23 (2007), Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976), and Aaron v. SEC, 446 U.S. 680, 701–02 (1980) (which holds that the scienter requirement applies to injunction proceedings brought by the SEC).

147. Tellabs v. Makor, 551 U.S. 308, 323 (2007) (quoting OXFORD ENGLISH DICTIONARY 949 (2d ed. 1989) (defining "strong")).

was meant to filter complaints which included facts able to raise the strongest or the most plausible of inferences.

Third, the *Tellabs* court provided realistic guidance to federal courts by recognizing that the strength of that inference can not be tested in a vacuum, and actually prescribes a clear step-by-step approach:

> *First, faced with a Rule 12(b)(6) motion to dismiss a §10(b) action, courts must, as with any motion to dismiss for failure to plead a claim on which relief can be granted, accept all factual allegations in the complaint as true. . . Second, courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice. . . Third, in determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences. . . The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite 'strong inference' of scienter, a court must consider plausible non-culpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff. The inference that the defendant acted with scienter need not be irrefutable, i.e., of the 'smoking-gun' genre, or even the most plausible of competing inferences.*[148]

Once all proper competing inferences are drawn on the basis of the complaint and the competing motions, a court should conclude "[a] complaint will survive. . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[149]

Fourth, the *Tellabs* decision resolves a critical aspect of the pleading questions which arose after the passage of the PLSRA. Prior to *Tellabs*, it was not clear to a court whether each fact pled by the plaintiff needed to satisfy the strong inference of scienter requirement separately, or whether the mosaic theory should be the governing approach.[150] Clearly, the language of the court resolves this question by incorporating the mosaic theory in the legal framework federal courts must use in the scienter analysis by noting that all inferences must be considered in evaluating a

148. *Id.* at 322–24.

149. *Id.* at 324.

150. *See* Danniella Casseres, Comment, South Cherry Street, LLC v. Hennessee Group LLC: *Investors' Desperate Plea for Second Circuit Standards*, 6 J. BUS. & TECH. L. 231, 241–43 (2011) (discussing the varying standards adopted by different circuits regarding the pleading of scienter).

complaint under the PSLRA, those favorable and unfavorable to the plaintiff.[151] Based on this analysis, the court endorsed the approach already adopted by the Fifth and Ninth Circuits which stressed "when determining whether plaintiffs have shown a strong inference of scienter, the court must consider *all* reasonable inferences,"[152] and that on such motions, when determining whether a strong inference of scienter has been pled, district courts should "make an individualized assessment that sweeps before it *the totality of the facts* in a given case."[153]

Fifth, Justice Ginsburg confirmed the burden to the plaintiff in the motion to dismiss, which consisted of providing enough particularized facts enabling the "strong inference of scienter" to comply with a preponderance of the evidence burden, because "a plaintiff is not forced to plead more than she would be required to prove at trial."[154]

The *Tellabs* decision provides a new framework for federal courts to apply a scienter analysis of Section 10(b) securities fraud claims. As applied to the public accounting industry, the *Tellabs* framework represents a significant change which will require courts to modify their approach in concluding at the pre-trial motion to dismiss stage whether a plaintiff satisfied the PSLRA heightened pleading requirement. To do so, a circuit court will have to draw all proper inferences, then conclude whether a "reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[155]

This new test is significantly different than the Ninth Circuit motive and opportunity approach and rejects the most plausible inference approach from the Second Circuit. Rather the *Tellabs* decision tends to support the Sixth Circuit's approach, and abandons any subjective factor such as the defendant's motive or opportunity.[156]

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151. *Tellabs*, 551 U.S. at 324.

152. Gompper v. VISX, Inc., 298 F.3d 893, 897 (9th Cir. 2002).

153. *In re* Credit Suisse First Boston Corp., 431 F.3d 36, 46 (1st Cir. 2005) (emphasis added). Federal courts have been quick to endorse the totality of circumstances test pronounced in *Tellabs*. *See* Middlesex Retirement System v. Quest Software Inc., 527 F. Supp. 2d 1164, 1191 (C.D. Cal. 2007) ("[u]nder *Tellabs* and *Gompper* the Court must consider these facts in their totality").

154. *Tellabs*, 551 U.S. at 323, 328–29.

155. *Id.* at 324.

156. *See* Kevin P. Roddy, *Nine Years of Practice and Procedure Under the Private Securities Litigation Reform Act of 1995*, A.L.I. 36–40 (July 8, 2005), http://www.wilentz.com/files/articlesandpublicationsfilefiles/82/article publicationfile/roddywebsiteattachmentjune2005.pdf (describing a number of cases in the Second Circuit applying the "motive and opportunity" formulation for pleading scienter).

III. THE FEDERAL "COMMON LAW" STANDARD APPLIED TO AUDITORS NEEDS TO BE RECONCILED WITH THE SECTION 404(B) REQUIREMENTS

A. The PCAOB Oversight

The implementation of the Sarbanes-Oxley Act has had a significant impact on the public accounting firm: For the first time, the accounting industry is directly regulated by a private-sector non-profit organization, the Public Company Accounting Oversight Board (or PCAOB), which oversees registered public accounting firms and acts as a direct emanation of the SEC.[157] Under the Sarbanes-Oxley Act,[158] the SEC appoints the Board's members after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury.[159] Unlike the prior oversight body (AIPCA), the budget of the PCAOB is approved by the SEC and is funded by feeds mostly paid by the U.S. issuers, which preserves independence from the accounting industry.[160] Under Section 101 of the Sarbanes-Oxley Act, the PCAOB is the entity entrusted to register public accounting firms that prepare audit reports, to set all of the auditing and ethical standards supporting the preparation of audit reports by issuers, and to conduct periodic inspections of the public accounting firms.[161] Like the SEC, the PCAOB has the power to conduct investigations and disciplinary proceedings against accounting firms or their partners, and may impose sanctions upon either the firms or associated persons.[162]

In 2006, an accounting firm and a conservative non-profit group challenged the constitutionally of the PCAOB, on the grounds that the PCAOB violates separation-of-powers principles, the Appointments Clause,[163] and the non-delegation doctrine.[164] In 2010, the U.S. Supreme Court upheld the constitutionality of PCAOB, with the exception of the conditions for removal of Board members.[165]

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157. *See* Sarbanes-Oxley Act of 2002 §101(a), 15 U.S.C. §7211(a) (2012).

158. *See* 15 U.S.C. § 7211(e)(4) (2010). The SEC named the first Board members on October 25, 2002. The Act requires that two of the five Board members be or have been certified public accountants. The Act also requires that all members of the Board serve on a full-time basis. *See* http://www.pcaobus.org/About_the_PCAOB/The_Board/index.aspx.

159. *Id*.

160. 2014 budget is $258.4 million, *SEC Approves 2014 PCAOB Budget and Accounting Support Fee*, (Feb. 14, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540791494#.Uwu0f3lzrwI.

161. *See supra* note 155.

162. *See* 15 U.S.C. § 7215(c)(4) (2010).

163. *See* Free Enter. Fund v. The Pub. Co. Accounting Oversight Bd., 130 S.Ct. 3138 (2010).

164. *Id*.

165. *Id.*

B. The Sarbanes-Oxley Section 404(b) Requirements

Section 404 represents the most controversial of Sarbanes-Oxley's new obligations. Section 404(a) puts the burden on the issuer to attest that the annual report must contain an internal control report expressing two key outcomes, which are management's acknowledgment of responsibility for establishing and maintaining adequate internal controls for financial reporting, and management's assessment as to the effectiveness of the internal controls.[166] Additionally, Section 404(b)[167] puts the burden on the public accounting firm in charge of auditing the issuer's financial statements to certify its independent evaluation of management's assessment of internal controls.[168] Under Section 404(b), the company's auditors "shall attest to, and report on, the assessment made by the management of the issuer."[169] Pursuant to its newly created statutory power,[170] and to ensure a uniform enforcement of this mandate, the PCAOB needed to implement this requirement on auditors via the publication of an Accounting Standard,[171] which would allow the auditor to consistently implement the attestation and report required by Section 404(b). To fulfill this obligation, on March 9, 2004, the PCAOB adopted Auditing Standard No. 2 ("AS 2").[172] This standard established the approaches an auditor must use to comply with section 404(b)'s attestation to management's assessment of the

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166. *See* 15 U.S.C. § 7262(a) (2012).

167. 15 U.S.C. § 7262(b) (2012).

168. For the SEC's view on the definition of the "Internal Control Over Financial Reporting," *see* 17 C.F.R. § 240.13a-15 ("The term internal control over financial reporting is defined as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.").

169. 15 U.S.C. § 7262(b) (2012).

170. Sarbanes-Oxley Act of 2002, § 103(a)(1), 15 U.S.C. § 7213(a)(1) (2007). Section 103(a)(1) directs the Board to establish auditing and related attestation standards to be used by registered public accounting firms, as may be necessary or appropriate for the protection of investors.

171. *Id.*

172. *See* Pub. Co. Accounting Oversight Bd., auditing standard no. 2: an Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (2004) [hereinafter AS 2], *available at* http://pcaobus.org/Rules/Rulemaking/Docket008/2004-03-09_Release_2004-001-all.pdf, effective pursuant to Order Approving Proposed Auditing Standard No. 2, Exchange Act Release No. 49,884, 69 Fed. Reg. 35,083 (S.E.C. June 17, 2004), *available at* http://www.sec.gov/rules/pcaob/34-49884.htm.

effectiveness of its internal control. Under AS 2, the auditor must test the internal controls of the issuer in a systematic fashion through sampling methodologies, and to preserve the independence of the work and the certification of the auditor, cannot be involved in the controls performed by the issuer.[173] The goal of this process is to ensure that the auditor obtains a full understanding of the operating effectiveness of the internal controls systems of the issuer, and may express a proper opinion on the effectiveness of the internal controls systems and on management's assessment of their effectiveness.[174] Beyond the compliance costs involved in these testing processes, this standard creates a number of obligations which have the potential to greatly impact the legal liability of the auditor in the future.

First, unlike prior auditing standards issued by the ICPA, whereby the auditor was allowed enormous discretion in the size and extent of the testing process performed by the auditor to audit financial transactions, Section 404(b) along with AS 2, requires the auditor to engage in a complete and full-scale control audit of enough transaction and processes to enable him to certify to effectiveness of the issuer's control systems.[175] In the context of a Section 10(b) cause of action against the auditor, this new approach may considerably diminish a defense of ignorance against the claim of knowledge required in the scienter analysis.[176] Prior to the Sarbanes-Oxley Act, because a financial audit was highly dependent upon the size and representativeness of the sampling performed during the audit, a defense of negligence was available to the auditor if the fraud or misrepresentation involved activities not covered in the sample of activities covered by the audit. Under Section 404(b), the requirement of a complete coverage of all internal controls necessary for the auditor to comply with the certification considerably diminishes the availability of this defense. Under Section 404(b), a defense of lack of actual knowledge by the auditor of a wrong, fraud, or misrepresentation could easily be countered with an inference of the auditor's knowledge of the processes and controls of the issuer.

Second, the approach of AS 2 creates a distinct obligation for the auditor to perform its own testing of the effectiveness of the internal control systems, rather than just relying on or endorsing the testing and the assessment of the issuer.[177] This approach will also render unavailable a defense of reliance on testing procedures and results originating from the entity, where the financial controls may

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173. *Id.* at §§ 51–52.

174. *Id.* at §§ 153–155.

175. *Id.* at §§ 150–51, 157.

176. *See* Miriam A. Cherry, *Whistling In The Dark? Corporate Fraud, Whistleblowers, and The Implications of the Sarbanes-Oxley Act for Employment Law*, 79 WASH. L. REV. 1029, 1074 n.308 (2004). ("As auditors must now apprise the audit committee of the details of the internal controls, or lack thereof, ignorance is no longer a defense.").

177. AS 2, *supra* note 162, §§ 161–166.

have been deficient, insufficient, or in the worst case, designed to prevent finding a specific accounting fraud or financial misrepresentation.

Third, the auditor now has an affirmative duty to disclose a material weakness or a significant deficiency in the internal controls of the issuer,[178] which is a separate obligation from the requirement to issue an adverse opinion on the representativeness of the financial statements.[179] The failure of the auditor to comply with this obligation to warn of the lack of effectiveness in the internal controls considerably increases its liability, at least vis-à-vis the PCAOB.[180]

While the reliability of such warnings is the subject of an intense debate, the legal implications of these new requirements may be substantial.

First, the primary impact of requiring the auditor to make an affirmative statement on the effectiveness of the financial controls that support the financial statements the auditor also certifies to is that the plaintiff investor's attempt to make the auditor a primary actor will be greatly enhanced. Any presumption that the auditor may not have been exposed to a material event which did not find its way into the financial statement, or that the auditor may not have been aware of significant financial fraudulent activities, will be considerably diminished.[181] Under *Stoneridge* the risk to the auditor for failing to submit an affirmative statement may be reduced because a secondary actor is not liable for aiding and abetting under Section 10(b).[182] However, the failure to submit an affirmative statement may continue to be indicia of fraud and expose the accountant to civil liability if the plaintiff can show that it relied upon the lack of affirmative statement, along with other deceptive acts.[183]

In addition, the liability of the auditor may be increased in situations where the financial statements opinion and the internal control opinions diverge,[184] most

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178. *Id.* at §§ 175–177.

179. *Id.*

180. *See* Thomas C. Pearson & Gideon Mark, *Investigations, Inspections and Audits in the Post-SOX Environment*, 86 NEB. L. REV. 43, 87 (2007) ("If a registered CPA firm does not cooperate with an investigation, the PCAOB may institute a disciplinary proceeding. Non-cooperation is evident if the CPA firm 'failed to comply with [a PCAOB] demand, . . . knowingly made any false material declaration,' or 'abused the [PCAOB's] processes for purposes of obstructing an investigation . . . .' If it appears to the PCAOB that disciplinary proceedings are appropriate, the PCAOB must conduct a non-public hearing. Disciplinary cases from the PCAOB become public if the PCAOB makes a final determination, such as the imposition of sanctions. Permissible sanctions include temporarily suspending or permanently revoking registration, barring an individual from further association with a registered CPA firm, prohibiting a firm from accepting new audit clients for a period of time, or imposing significant civil monetary penalties.").

181. *Id.*

182. *Stoneridge*, 128 S.Ct. 761.

183. *Id.* at 769.

184. The auditor will deliver three separate opinions: the traditional opinion on the financial statements, and two opinions concerning internal controls (one commenting on management's assertions pursuant to Section 404(b) and the other detailing the auditor's own conclusions concerning internal control pursuant to Auditing Standard No. 2). *See* AS 2, *supra* note 168, §§ 207–211.

notably where a material weakness in internal controls is reported, but an unqualified opinion on the financial statements is submitted.

Furthermore, the inclusion of the AS 2 obligations in the 1934 Act periodic reporting requirements ensures that the auditor certifications appear in periodic communications, and systematically provide valuable information to potential plaintiffs.[185] This aspect is critical in the context of the PSLRA requirements, which prevents discovery at the pre-trial motion for summary judgment, because the plaintiff is forced to rely either on public information or on the results of its own investigations.

C. The Implementation of the Section 404(b) Requirements through Accounting Standard No. 5

In May 2007, following considerable criticism from the auditing industry, issuers, and small businesses, based on the Section 404 compliance costs, the PCAOB approved a new auditing standard to replace AS 2 with Auditing Standard No. 5 ("AS 5").[186] AS 5 accomplishes two main changes which have a significant impact on the potential liability of auditors.

The first change was the simplification of the Section 404(b) requirements, most notably by allowing the auditor to focus on the most material areas of internal controls, rather than an exhaustive testing requirement.[187] Therefore, AS 5 eliminates the requirement that the auditor must perform a walk-through for each significant process before selecting controls to test. This allows the auditor to select appropriate procedures based on the risk to financial statement assertions. Using this assessment, the auditor selects the controls to test and the procedures to use based on the risk of a material weakness.[188] One could argue that this may improve the ignorance defense of the auditor because the auditor may forego an exhaustive testing process and could argue that some areas of the entity he did not investigate were the sources of the alleged fraud by plaintiffs. However, this argument will be ineffective because the burden remains on the auditor to select the areas which are

185. *See* Sarbanes-Oxley Act of 2002, §103(a)(1), 15 U.S.C. §7213(a)(1) (2007). When, on June 17, 2004, the SEC issued its Order Approving Proposed Auditing Standard No. 2, see *supra* note 168, this order triggered the inclusion of the Auditing Standard 2 certification requirements in several SEC rules and forms which incorporate the certifications in periodic filings (e.g. section 2-02 of Regulation S-X requires the company's registered public accounting firm to attest to management's assessment of internal control over financial reporting in the annual report).

186. Pub. Co. Accounting Oversight Bd., Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements (2007) [hereinafter AS5], *available at* http://pcaobus.org/Rules/Rulemaking/Docket%20021/2007-06-12_Release_No_2007-005A.pdf, effective pursuant to Order Approving Proposed Auditing Standard No. 5, Exchange Act Release No. 34-56152, 72 Fed. Reg. 42141 (S.E.C. July 27, 2007) [hereinafter AS5 Order], *available at* http://www.sec.gov/rules/pcaob/2007/34-56152.pdf.

187. AS 5, *supra* note 186, §§ 46–47.

188. *Id.*; *see also* AS 5 Order, *supra* note 186, at 42144.

appropriate to test any controls which have a material impact on the financial statements of the issuer. Therefore, the ignorance defense will likely be eliminated by the affirmative obligation for the auditor to provide a substantially complete picture of the effectiveness of the internal controls on the basis of materiality.

The second accomplishment of AS 5 is a formal definition endorsed by the PCAOB and the SEC of the concepts of "material weakness" and "significant deficiency." The SEC endorsed a clear definition of "material weakness," which is "a deficiency, or a combination of deficiencies, in ICFR ["internal control over financial reporting"] such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis."[189] This new probability standard represents a significant change because it only requires a "reasonable possibility," which is a higher standard than the previous requirement of a "more than a remote likelihood."[190] This change will strengthen the auditor's defense because he will no longer be required to test every control which may have a small probability of having a material impact on the material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis. In addition, AS 5 requires management to disclose all "significant deficiencies" to the audit committee and external auditors.[191] Unlike the definition of "material weakness," the definition of "significant deficiency" does not specifically include a likelihood component but instead relies on the sufficient and appropriate judgment of management in deciding what deficiencies should be reported to the auditors and the audit committee. Therefore, significant deficiencies are not necessarily material weaknesses, but are items which require disclosure only to the audit committee.

Since AS 2, the identification of a "material weakness" by an auditor had considerable consequences, since its existence requires the auditors to deliver an adverse control opinion and to disclose this opinion to the financial markets.[192] Obviously, such an opinion is stigmatizing and likely to be negatively perceived by

189. *See* Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, Exchange Act Release No. 34-55928, 72 Fed. Reg. 35310, 35313–14 (S.E.C. June 20, 2007). Following the approval of Auditing Standard No. 5, the SEC has amended Rule 12b-2 of the Exchange Act and Rule 1-02 of Regulation S-X.

190. *Id.*; AS 5, *supra* note 186, § A7. This definition abandons the "*more than a remote likelihood* that a *material* misstatement of the financials will not be prevented or detected" standard of AS 2. AS 2, *supra* note 172, § 10 (emphasis added).

191. *See* 17 C.F.R. § 210.1-02(a)(4) (2013) ([whereas a significant deficiency is] "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting").

192. AS 5, *supra* note 186, at 10.

investors.[193] Even if the stock market ignores the opinion, the one body that cannot be indifferent to it is the audit committee. Inherently, such an opinion places them on notice that the entity may not be able to produce accurate and reliable financial information, in which case significant liability under a duty of care violation theory could emerge.[194] Because adverse opinions will be painful for all, it is predictable that auditors will seek to avoid rendering them. The simplest route to this end is for the auditor to decide that an internal control problem or irregularity amounts only to a "significant deficiency," but not a "material weakness." Separating these two types of weakness is only a matter of degree. According to AS 2, "significant deficiencies" pose "more than inconsequential" risks for financial statement reliability, while "material weaknesses" pose "material risks" for financial statement reliability. Much as the two may sound alike, they require very different responses from the auditor. "Material weaknesses" must be publicly disclosed and their nature and impact explained by the auditor, while "significant deficiencies" need only be brought to the attention of the audit committee.[195]

Both AS 2 and AS 5 are likely to alter the securities fraud exposure of the auditor: prior to the Sarbanes-Oxley Act, undetected material weaknesses in internal controls were not considered a threshold issue sufficient to raise and assign liability to the auditor.[196] Courts generally found that scienter could not be inferred merely from the fact that the auditor relied on inadequate internal controls.[197] This is the critical judicial assumption which will now be significantly challenged by the Section 404(b) requirement. First, the AS 5 requirement of an affirmative disclosure of a "material weakness" will likely limit or defeat ignorance-based defenses by auditors. Additionally, because a statutory relationship now exists between the internal control deficiencies and the certification of the financial statements, the

193. *See* Helen Shaw, *Material-Weakness Reports Skyrocket*, CFO.COM (Jul. 18, 2005), http://www.cfo.com/printable/article.cfm/4193977?origin=archive.html ("A total of 586 companies reported material weaknesses through early May of this year, compared with 313 for all of 2004, according to shareholder-advisory firm Glass, Lewis & Co.").

194. *See* John C. Coffee, Jr., *SOX Section 404 and Auditing Standard No.2: The New Disclosure Landscape*, *available at* Westlaw SK017 ALI-ABA 531, 535–37 (2004) ("Obviously, such an opinion is stigmatizing and likely to be confusing to investors. Even if the stock market ignores the opinion, the one body that cannot be indifferent to it is the audit committee. Inherently, such an opinion places them on notice that the firm may not be capable of producing accurate and reliable financial information. If they do not move promptly to correct any control deficiency, they could be plausibly alleged to have violated their Caremark duty to monitor—at least if a later financial restatement or scandal arises. In addition, directors who do nothing in this context may be found not to have acted in 'good faith'; recent Delaware decisions have tightened the definition of 'good faith,' which is a prerequisite for the availability of Section 102(b)(7)'s charter provision eliminating due care liability.").

195. AS5, *supra* note 186, at 10.

196. *See infra* Part IV.

197. *See infra* Part IV; *see also infra* Appendix 1.

circuit courts will have to take into account inferences created by the presence of a material weakness disclosure or by the absence of such a disclosure.[198]

D. The impact of the Sarbanes-Oxley certifications on the federal case law.

Following the implementation of AS 5, the question of the legal impact of these new certifications immediately surfaced in the federal case law. However, the first decisions which analyzed the impact of these new obligations were limited to cases involving company insiders not public accounting firms. In addition, as the frequency of Section 10(b) claims is disproportionately higher than Section 11 claims,[199] courts were first confronted with the impact of these new certifications on their potential value as evidence of scienter in Section 10(b) claims. Courts recognized that the impact of a failure to meet the new certification obligations on the legal liability of the corporate insiders was unchartered territory, and recent decisions show mixed judicial views.

In *In re Watchguard*, although recognizing that the impact of "a Sarbanes-Oxley certification has on a Rule 10b-5 claim is a relatively novel question," the court refused to find that these certifications represented "a basis for a strong inference of scienter," because the certifying Defendants [already] knew about [the] revenue recognition problems as a result of the accounting controls that they certified were in existence."[200]

In *Garfield v. NDC Health*,[201] the U.S. Court of Appeals for the Eleventh Circuit refused to recognize that scienter would be established in every case where there was an accounting error or auditing mistake made by a publicly traded company

198. *See* Coffee, *supra* note 194, at 539 ("Traditionally, material weaknesses in internal controls were not considered material in their own right. Plaintiffs could still assert liability and satisfy their obligation to plead with particularity if they were able to show that in response to its discovery of material weakness in internal controls, the auditor failed to expand its substantive audit testing, as 'generally accepted auditing standards' required it to do. Similarly, the case law generally found that scienter could not be inferred merely from the fact that the auditor relied on inadequate internal controls. Rather, some connection needed to be shown between internal control deficiencies and its audit of the financial statements. If the auditor responded to its recognition of inadequate internal controls by expanding the scope of its audit testing, it was probably safe. All this changes after Auditing Standard No. 2. In Section 11 cases involving primary offerings, the plaintiffs who purchased registered securities need only show a material omission, and the burden would then shift to the defendant auditor to demonstrate that it satisfied its due diligence defense or that the investors' loss was not causally related to the omission. Material weaknesses that once had to be reported only internally now have to be publicly disclosed. Although such an omission is not per se material, the odds are high that, in the typical case involving financial irregularities, it will enhance the settlement value of the plaintiffs' case.").

199. *See Securities Class Action Settlements 2002: A Year in Review*, Cornerstone Research 11 (2003), http://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Settlements-2002-A-Year-In.
Figure 10 ("Settlements by Nature of Allegations 2002 Settlements") shows that approximately 7% of cases which led to a settlement in 2002 involve a section 11 claim, whereas approximately 90% of these cases included at least one Section 10(b)/Rule 10b-5 claim.

200. *In re* Watchguard Sec. Litig., Master File No. C05-678JLR, 2006 U.S. Dist. LEXIS 27217, at *29 (W.D. Wash. Apr. 21, 2006).

201. 466 F.3d 1255 (11th Cir. 2006).

because a possible "interpretation of Sarbanes-Oxley conflicts with the plain language of the PSLRA",[202] thereby eviscerating the pleading requirements for scienter set forth in the PSLRA."[203] However, the *Garfield* court did recognize that "a Sarbanes-Oxley certification is. . . probative of scienter if the person signing the certification was severely reckless in certifying the accuracy of the financial statements."[204]

Finally, the U.S. District Court for the District of Oregon was the most aggressive in recognizing that "[w]hile any of [the accounting] allegations standing alone would not necessarily demonstrate *scienter*,"[205] the Sarbanes-Oxley certifications provided an inference of at least deliberate recklessness, and would "give rise to an inference of scienter because they provide evidence either that defendants knew about the [accounting misrepresentations] or, alternatively, knew that the controls they attested to were inadequate."[206] Therefore, these certifications, "in combination with plaintiffs' allegations. . . are sufficient to create a strong inference of actual knowledge or of deliberate recklessness."[207] Although the *Watchguard, Garfield,* and *Lattice* decisions represent holdings involving corporate insiders, a similar reasoning may apply to the Section 404(b) certifications by the auditor, because of the extent of knowledge and understanding such certifications warrant on the underlying nature of the business, the processes in place with the client to manage the business, and the ensuing financial statements.[208] Consequently, the rule which seems to emerge from these three cases is a strong indicator of the future liability of auditors. All three courts agree that a Section 404(b) certification, standing alone, is not a sufficient condition to establish scienter.[209] Also, all three courts agree that, should plaintiffs show specific allegations of reckless conduct by corporate insiders, the Section 404(b) certification would be reviewed as additional indicia of scienter, where it could show defendants "either knew of the book cooking or knew that their financial controls were inadequate."[210] All three courts refused to "transform the PSLRA's requirement of falsity-plus-scienter into a requirement of falsity-plus-a-Sarbanes-Oxley-certification,"[211] and all three decisions were rendered prior to *Tellabs*.[212]

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202. *Id*. at 1266.

203. *Id*.

204. *Id*.

205. *In re* Lattice Semiconductor Corp. Sec. Litig., No. CV04-1255-AA, 2006 WL 538756, at *1 (D. Or. Jan. 3, 2006), *abrogated by* Zucco Partners, LLC v. Digimarc Corp., 552 F. 981 (9th Cir. 2009).

206. *Id.* at *18.

207. *Id.*

208. *See supra* note 102.

209. *See supra* notes 199, 200, and 203.

210. *In re* Watchguard Sec. Litig., Master File No. C05-678JLR 2006 U.S. Dist. LEXIS 27217, at *33 (W.D. Wash. Apr. 21, 2006).

211. *Id.* at *34.

212. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007).

IV. ANALYSIS

A. The Pre-Tellabs Federal Common Law Standard of Scienter Analysis for the Auditor.

Even though the legal standard of scienter was subject to various interpretations amongst the federal circuits after the PSLRA became law, courts did share common analysis principles to rule on the scienter pleading requirement. An analysis of sixteen decisions across all circuits between 1999 and 2007 included eight decisions where courts dismissed the complaint against the auditor and eight decisions where courts rejected the auditor's motion to dismiss.[213] In all of these decisions common criteria emerge even though the approaches to the scienter analysis differ because of the various PSLRA interpretations across the circuit courts.[214]

First, the level of required recklessness necessary to comply with *Ernst & Ernst* must be so strong as to lead to a substantial abandonment of the professional duty of the auditor: "Recklessness on the part of an independent auditor entails a mental state so culpable that it 'approximate[s] an actual intent to aid in the fraud being perpetrated by the audited company.'"[215] In this view, scienter "requires more than a misapplication of accounting principles. The [plaintiff] must prove that the accounting practices were *so deficient* that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts."[216]

Second, at the summary judgment stage, courts consistently impose on the plaintiff an awareness requirement because "when the standard of recklessness for an auditor is overlaid with the pleading requirements of the PSLRA, a simple rule emerges: to allege that an independent accountant or auditor acted with scienter, the complaint must allege specific facts showing that the deficiencies in the audit

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213. *See infra* Appendix 1.

214. *See supra* note 95.

215. *In re* Cardinal Health Sec. Litig., 426 F. Supp. 2d 688, 763 (S.D. Ohio 2006) (citing Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 121 (2d Cir. 1982); Pegasus Fund, Inc. v. Laraneta, 617 F.2d 1335, 1341 (9th Cir. 1980) (noting that an auditor's recklessness "must come closer to being a lesser form of intent [to deceive] than merely a greater degree of ordinary negligence" (internal quotations omitted))).

216. PR Diamonds Inc. v. Chandler, 364 F.3d 671, 693–94 (6th Cir. 2004) (emphasis added) (citing *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1426 (9th Cir. 1994)).

were so severe that they strongly suggest that the auditor must have been aware of the corporation's fraud." [217]

Third, federal courts consider the presence of several factors, although they do not provide any indication as to the minimum number of factors required to meet the minimum threshold of recklessness or scienter by the auditor. However, courts will defeat the auditor's motion to dismiss where most of the following factors are established: (1) the auditor violated GAAP or GAAS;[218] (2) the accounting irregularities were of significant magnitude, i.e. whether the impact of the violations, the alleged fraud or of the misstatements or improprieties were material;[219] (3) numerous and significant "red flags,"[220] which are "those facts which come to the attention of an auditor which would place a reasonable auditor on notice that the audited company was engaged in wrongdoing to the detriment of its investors;"[221] and (4) violation of internal policies or weaknesses in internal controls known to the auditor.[222] On the other hand, courts will dismiss the plaintiff's

217. *Cardinal Health*, 426 F. Supp. 2d at 764 (quoting *PR Diamonds*, 364 F.3d at 693); *see also* Decker v. Massey-Ferguson, Ltd., 681 F.2d at 120–21 ("Assuming for the argument that recklessness on the part of a non-fiduciary accountant will satisfy [the] requirement of scienter, such recklessness must be conduct that is highly unreasonable, representing an extreme departure from the standards of ordinary care. It must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company." (internal citations omitted)); McLean v. Alexander, 599 F.2d 1190, 1198 (3d Cir. 1979) (noting that scienter can be established by a "showing of shoddy accounting practices amounting at best to a pretended audit, or of grounds supporting a representation so flimsy as to lead to the conclusion that there was no genuine belief [in] back of it" (internal citations omitted)).

218. *See In re* Hamilton Bankcorp., Inc. Sec. Litig., 194 F. Supp. 2d 1353, 1359 (S.D. Fla. 2002) ("In instances where plaintiffs have pled facts explaining how the standards were recklessly or consciously violated, however, courts have found them probative.") (internal citations omitted).

219. *See In re* Rent-Way Sec. Litig., 209 F. Supp. 2d 493, 506 (W.D. Pa. 2002) ("[A] number of courts have recognized that the magnitude of the fraud, while not determinative of scienter, is probative of it.") (internal citations omitted); *see also* P. Schoenfeld Asset Mgmt., LLC v. Cendant Corp., 142 F. Supp. 2d 589, 608 (D.N.J. 2001) (aside from a violation of GAAP, other circumstances suggesting fraudulent intent can include the presence of red flags and the magnitude of the alleged fraud).

220. In securities litigation, "red flags" are "'specific, highly suspicious' facts and circumstances available to the auditor at the time of the audit." *In re* Bally Total Fitness Sec. Litig., No. 04-C-3530, 2007 WL 551574, at *11 (N.D. Ill. Feb. 20, 2007) (citing Riggs Partners, LLC v. Hub Group, Inc., No. 02-C-1188, 2002 WL 31415721, at *9 (N.D. Ill. Oct. 25, 2002)). "Red flags" are also described as "circumstances that would have put the defendants on notice that [Cardinal's] financial statements and press releases contained material misstatements or omissions, or at least would have given them reasons to question the veracity of the statements." *Cardinal Health.*, 426 F. Supp. 2d at 738–39 (citing PR Diamonds, Inc. v. Chandler, 91 F. App'x. 418, 432 (6th Cir. 2004)).

221. Garfield v. NDC Health Corp., 466 F.3d 1255, 1268 (11th Cir. 2006) (citing *In re* Sunterra Corp. Sec. Litig., 199 F. Supp. 2d 1308, 1334 (M.D. Fla. 2002)).

222. *See Rent-Way*, 209 F. Supp. 2d at 508 ("We find that these allegations are of the requisite particularity and that they, similar to the allegations in *In re Ikon,* paint a picture of PwC as knowledgeable about the significant problems in its client's internal control systems and as having reason to know that these problems were occurring when it issued its unqualified audit opinions. Accordingly, we find that Plaintiffs' claims regarding PwC's knowledge in this respect are probative of scienter." (citing *In re* Ikon Office Solutions, Inc. Sec. Litig., 66 F. Supp. 2d 622, 632 (E.D. Pa. 1999)).

complaint when few of the above factors are present simultaneously,[223] when the GAAP violations are less egregious in nature and magnitude, where the alleged red flags would lack significant magnitude or would not rise to the level of a symptom of a inadequate audit process or are conclusory in nature,[224] where the plaintiff's claim would constitute no more than second-guessing an audit process which was accomplished according to proper GAAS procedures,[225] or when plaintiff is not putting forward any indicia that the auditor knew of the accounting misconduct or improprieties. In these cases, red flags alone, or GAAP violations alone, or second-guessing of auditor calculations or audit procedures are not sufficient.[226]

B. Impact of the PCAOB Administrative Case Law, Combined with the Section 404(b) Certification on the Federal Common Law Test

The creation of the PCAOB by the Sarbanes-Oxley Act was a direct response to the perceived failure of the system of self-regulation of auditors, which was described as "a Byzantine structure of accounting disciplinary bodies which generally lack adequate and assured financial support, clear and undivided responsibility for discipline, and an effective system of SEC oversight."[227] To implement a system of independent regulation, the Sarbanes-Oxley Act provided a broad enforcement mandate to the PCAOB, by vesting the Board with the authority to register public accounting firms, to define auditing standards for auditing, ethics and independence, to inspect the largest public accounting firms, to investigate the firms and associated persons for violations of PCAOB-issued rules, and impose

223. *See In re* Ikon Office Solutions, Inc. Sec. Litig., 277 F.3d 658, 673 (3d Cir. 2002) ("[T]he discovery of discrete errors after subjecting an audit to piercing scrutiny post-hoc does not, *standing alone*, support a finding of intentional deceit or of recklessness." (emphasis added) (citing *In re* Software Toolworks Inc., 50 F.3d 615, 627 (9th Cir. 1994) ("the mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter"))); *see also* SEC v. Price Waterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992) (misapplication of accounting principles by an independent auditor, alone, is insufficient to establish scienter).

224. Nappier v. Pricewaterhouse Coopers LLP, 227 F. Supp. 2d 263, 278 (D.N.J. 2002) ("[S]o-called 'red flags,' which should be deemed to have put a defendant on notice of alleged improprieties, must be closer to 'smoking guns' than mere warning signs.") (citations omitted).

225. *See* In re *Ikon Office Solutions*, 277 F.3d at 673 ("To give rise to section 10(b) liability for fraud, the mere second-guessing of calculations will not suffice; appellants must show that [the auditor]'s judgment-at the moment exercised-was sufficiently egregious such that a reasonable accountant reviewing the facts and figures should have concluded that IKON's financial statements were misstated and that as a result the public was likely to be misled."); *cf.* Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978) (rejecting "fraud by hindsight" allegation because lack of clairvoyance does not constitute fraud).

226. *See infra* notes 218–220 and accompanying text.

227. *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies*: *Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 107th Cong. 532 (2002) (statement of Joel Seligman, Dean & University Professor, Wash. Univ. Sch. of Law).

disciplinary sanctions against both firms and individuals for such violations, including censures, temporary suspensions, permanent bars and fines.[228]

This new oversight is leading to the formation of a body of administrative case law which should provide critical guidance to federal courts in modifying the legal test of scienter for auditors. In eleven enforcement cases decided to-date,[229] six of those involved "intentional or knowing conduct, including reckless conduct that results in a violation of the applicable statutory, regulatory, or professional standard."[230]

The PCAOB jurisprudence provides an important basis to illustrate its own threshold for scienter. In all cases, the firm or the professional subject to the PCOAB enforcement failed to adhere to the GAAP standards,[231] and either did not apply proper professional quality control procedures or failed to apply fraud detection guidelines.[232] Finally, the failure to remedy these violations following regular inspections, or the repetitive pattern of these violations across many audit

228. *See* Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and its Public/Private Status*, NOTRE DAME L. REV. 975, 977–78, 983 n.40 (2005); *see also* Thomas C. Pearson & Gideon Mark, *Investigations, Inspections, and Audits in the Post-SOX Environment*, 86 NEB. L. REV. 43, 87 (2007).

229. *Settled Disciplinary Orders*, PUB. CO. ACCOUNTING OVERSIGHT BD., http://pcaobus.org/Enforcement/Decisions/Pages/default.aspx (last visited Feb. 1, 2014).

230. The Sarbanes-Oxley Act preserves two clear avenues of enforcement for the Board, one which is similar to either one of the three readings of the Ernst & Ernst scienter standard, of either intentional, knowing or reckless conduct, and the other, consisting in the much lower threshold of negligent, but repetitive, conduct. Finally, a violation is not based upon a state of mind analysis, but is based upon an objective violation of any standard the Board or the SEC implements. Consequently, a technical violation of any of the standards defined in Auditing Standard 5 for instance, would constitute a "knowing" or "reckless" conduct, leading to the application of the sanctions under Section 105(c)(4). *See* Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7215(c)(4)(A)–(G) (2012).

231. Sanctions under the combined effect of Sections 105(c)(4) and 105(c)(5) of the Sarbanes-Oxley Act of 2002 were applied to a number of cases. In four cases, the PCAOB ordered the registration of the firm revoked, either temporarily or permanently, and in two cases, the accounting firms were censured. Three professional accountants were permanently barred and four professional accountants were temporarily barred. *See infra* Appendix 2.

232. As the PCAOB worked to define and adopt new Auditing Standards, it also adopted several pre-existing standards created by the AICPA's Auditing Standard Board. Among those, the Board, through PCAOB Release No. 2007-001, adopted AU § 316.68, *Consideration of Fraud in a Financial Statement Audit*. PUB. CO. ACCOUNTING OVERSIGHT BD., PCAOB RELEASE NO. 2007-001, OBSERVATIONS ON AUDITORS' IMPLEMENTATION OF PCAOB STANDARDS RELATING TO AUDITORS' RESPONSIBILITIES WITH RESPECT TO FRAUD, at 1, 6 (2007), *available at* http://pcaobus.org/Inspections/Documents/2007_01-22_Release_2007-001.pdf. However, in its release, the Board went further in stepping up the auditor's responsibility in detecting financial fraud by stating that the "auditor should, therefore, assess risks and apply procedures directed specifically to the detection of a material, fraudulent misstatement of the financial statements." *Id.* at 2. AU § 316.68 was deleted, but it was completely incorporated into Auditing Standard No. 14, Appendix C through PCAOB Release No. 2010-004, effective for audits of fiscal years beginning on or after December 15, 2010. PUB. CO. ACCOUNTING OVERSIGHT BD., PCAOB RELEASE NO. 2010-004, AUDITING STANDARDS RELATED TO THE AUDITOR'S ASSESSMENT OF AND RESPONSE TO RISK AND RELATED AMENDMENT TO PCAOB STANDARDS, at A10-86 (2010), *available at http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release_2010-004_Risk_Assessment.pdf*.

assignments usually constitutes an aggravating factor for the PCAOB.[233] In evaluating a claim against a public accounting firm, federal courts are only required to analyze the scienter requirement in light of both U.S. Supreme Court guidance and the PSLRA mandate, and are not bound by administrative rules or interpretation by federal agencies which resolve claims under their delegated mandate. Additionally, in case of conflicts between a judiciary review of an administrative rule and an agency interpretation of that rule, the federal courts would argue that their interpretation would win over the agency views, because the supremacy clause would enable the courts to subject a PCAOB's resolution of a claim against an auditor to judicial review principles.[234]

However, if challenged in federal court by an auditor claiming that the PCAOB rule or its application was "arbitrary and capricious, an abuse of discretion, or otherwise not in accordance with the law,"[235] the PCAOB could argue that its stricter interpretation of the scienter rule would resist any judicial challenge from an auditor claiming he was subject to a more severe scienter standard under the PCAOB rule than the federal common law rule because the PCAOB enforcement rule would be a permissible interpretation of the Sarbanes-Oxley Act, "the regulatory scheme is technical and complex, the agency considered the matter in a detailed and reasoned fashion, and the decision involves reconciling conflicting

233. *See* Armando C. Ibarra, P.C., Pub. Co. Accounting Oversight Bd., PCAOB Release No. 2006-009, at 4–13 (Dec. 19, 2006); Turner Stone & Company, LLP, Pub. Co. Accounting Oversight Bd., PCAOB Release No. 2006-010, at 9 (Dec. 19, 2006); Clyde Bailey, P.C., Pub. Co. Accounting Oversight Bd., PCAOB Release No. 2005-021, at 3–11 (Nov. 22, 2005).

234. *See* Marbury v. Madison, 5 U.S. 137, 177 (1803) (holding that the judiciary has the final authority to "say what the law is"). When different interpretations between the judiciary and the administrative agency are at-issue, the Administrative Procedure Act reinforces the Marbury holding by evaluating agency action under the "arbitrary and capricious" review standard. *See* Administrative Procedure Act § 706, 5 U.S.C. § 706 (2012) ("To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action.").

235. Administrative Procedure Act § 706(2)(A).

policies."[236] Consequently, it is technically possible for two scienter standards to co-exist, a strict scienter standard within the scope of the PCAOB jurisdiction, and a looser standard for scienter which may very well continue to develop after *Tellabs*.[237] Such a scenario would not be resolved under traditional conflict of laws principles, as the jurisdiction of the PCAOB is well delineated by the Sarbanes-Oxley Act and the federal courts jurisdiction for Rule 10b-5 claims would be protected by the 1934 Act and its U.S. Supreme Court jurisprudence. However, such a situation could lead to increasingly difficult positions for the judiciary. If the two standards start to significantly diverge, one could imagine two potential arguments by plaintiffs in federal courts. First under the Due Process Clause,[238] a plaintiff could argue "reversed arbitrariness" by the federal judiciary because the court, by applying too restrictive of a scienter requirement compared to the administrative interpretation of the same standard, abandoned the plaintiff's interests and violated the interest-balancing doctrine.[239]

Second, plaintiffs in the civil case against the auditor could rely on the argument made by Judge Wood in the Seventh Circuit Court of Appeals decision, *Makor*

236. Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 865 (1984). "When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." *Id.* at 842–43. Under the Chevron deference rule, the PCAOB would easily argue that it adheres to all three prongs of the U.S. Supreme Court analysis: the Sarbanes-Oxley regulatory scheme as it applies to the PCAOB rules, and its interactions with the 1933 and 1934 Acts, is based on highly technical and complex accounting rules and standards, such as GAAP and GAAS. The PCAOB rules regarding auditor standards have relied on professional review, such as the AICPA. The PCAOB accounting and disciplinary rules balance the interests of compliance with cost considerations, such as the changes brought by Accounting Standard No. 5 compared to Accounting Standard No. 2. Therefore, the PCAOB is almost certain to defeat any legal challenge of its disciplinary decisions under the Chevron and APA §706 standards.

237. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 328–29 (2007).

238. U.S. CONST. amend. XIV, § 1 ("All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.").

239. *See* Note, *Specifying the Procedures Required by Due Process: Towards Limits on the Use of Interest Balancing*, 88 HARV. L. REV. 1510, 1510 (1975) ("Due process adjudication typically involves two analytically distinct issues: whether the right to due process is applicable; and, if so, what procedures must be provided. Resolution of the first issue requires a finding as to whether the governmentally inflicted deprivation in question intrudes upon a liberty or property interest possessed by the individual. If the deprivation is found to be of a type which triggers the litigant's entitlement to due process, a determination must then be made of which specific procedures are required by the right. Under present doctrine the form of due process depends upon a utilitarian balancing of the conflicting interests in which the individual's need for requested procedural safeguards is weighed against the governmental interest in summary or informal action.").

Issues & Rights v. Tellabs,[240] when it noticed that too strong of an inference standard in evaluating scienter could potentially infringe upon plaintiffs' Seventh Amendment rights to a jury.[241] One could imagine that such an argument would find new force in the following situation: assume a plaintiff is defeated in its claim against an auditor in federal court under a less stringent scienter requirement, only to find out that the PCAOB held the auditor in violation of its Rules,[242] had warned the auditor in many inspections,[243] and ultimately disciplined or barred the auditor. Under this scenario, a Seventh Amendment violation argument may find new force, by arguing that the combination of the heightened pleading requirement and too high of a substantial scienter threshold prevented the plaintiff to present a valid case to a jury. Consequently, the PCAOB scienter standard should serve as persuasive authority for federal courts to confirm an inference of knowledge on the part of the auditor from the Section 404(b) certification.

V. SOLUTION

To prevent a continuing and increasing tension between the Sarbanes-Oxley Section 404(b) requirements, the heightened pleading requirements of the PSLRA, and administrative jurisprudence, courts should modify the legal analysis of the scienter requirement as applied to accountants by using a new approach consistent with both *Tellabs* and the PCAOB case law. This new framework[244] will rely on a few assumptions. First, the Section 404(b) requirement will be central to the analysis because it will determine whether the critical element of knowledge is met. The knowledge element is critical because the federal case law shows that the threshold issue is whether the accountant was aware of either a fraud, accounting improprieties, or of the weakness or absence of the appropriate controls necessary to detect the fraud or the improprieties. Second, *Tellabs* requires that, for a complaint to survive, "*a reasonable person* would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from

240. 437 F.3d 588 (7th Cir. 2006) (holding that plaintiff's complaint adequately alleged scienter as to statements made by Tellabs executives), *rev'd and remanded*, 551 U.S. 308 (2007).

241. *Id.* at 602 ("One might argue that for cases where a juror could conclude that the facts pleaded show scienter, but that conclusion would not be the most plausible of competing inferences, a Seventh Amendment problem is presented." (internal citation omitted)). Justice Ginsburg made sure that the *Tellabs* Court addressed that concern, which represented a significant amount of discussion during the oral arguments held on March 28, 2007. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 326–27 (2007) ("In our view, the Seventh Circuit's concern was undue. A court's comparative assessment of plausible inferences, while constantly assuming the plaintiff's allegations to be true, we think it plain, does not impinge upon the Seventh Amendment right to jury trial.").

242. *See supra* note 225.

243. *See* Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7214(g)(2) (2012). One could imagine the potential litigation between a plaintiff, an auditor, and the PCAOB, regarding the public release of the inspection reports during the 12-month interim period, especially if the auditor documented with the PCAOB the reasons why the report should not be released.

244. *See infra* Appendix 3.

the facts alleged."[245] Consequently, the *Tellabs* analysis requires an objective standard to determine whether the scienter requirement has been met. Because this approach essentially overrules the Second and Third Circuit's former "motive and opportunity" approaches, federal courts will have to seek objective factors in measuring all facets of the scienter analysis, and most specifically with the knowledge requirement. This element was precisely what the Sarbanes-Oxley Act and the PCAOB attempted to address by providing for disclosure rules consistent with the knowledge acquired by the auditor of the issuer's control processes through Section 404(b). Therefore, Accounting Standard No. 5, through the "significant deficiency" and "material weakness" disclosure mechanisms, provides tools consistent with the goals of Sarbanes-Oxley, and with the practices in line with PCAOB accounting standards.[246]

Applying this approach, it is urged that federal courts adopt the following framework when analyzing the scienter requirement of a claim against a public accounting firm.[247]

The first step in the analysis before examining all of the other inferences in the complaint should focus on the content of the Section 404(b) certification. The court would first review whether the accounting firm complied with the Section 404(b) disclosure, then which disclosure was made. In the case of a material weakness disclosure, the defendant auditor will be able to defeat the impact of the inference of knowledge[248] by arguing he complied with his statutory obligation to affirmatively disclose material weaknesses to the "Internal Control Over Financial Reporting."[249] This disclosure, which brings significantly negative consequences to the issuer,[250] actually functions as an insurance policy against liability. However, it

245. *Tellabs*, 551 U.S. at 324 (emphasis added).

246. *See supra* notes 188–89.

247. This framework would be applied in the third step described in the *Tellabs* analysis. *See Tellabs*, 551 U.S. at 323 ("Third, in determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences.").

248. *But see* Lawrence A. Cunningham, *Facilitating Auditing's New Early Warning System: Control Disclosure, Auditor Liability and Safe Harbors*, 55 Hastings L.J. 1449, 1478 (2004) (claiming that the material weakness disclosure rules under Auditing Standard No. 2 functions as a disincentive to disclosure, due to their negative consequences).

249. This is a defined term for the PCAOB. *See* AS 5, *supra* note 181, § A5 (2007) (internal control over financial reporting, includes those policies that: "(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements").

250. *See* C. Brune, *Study Reveals Impact of Disclosing Weaknesses*, Internal Auditor, Feb. 2005, at 22 (announcing that, based on a study conducted by A.R.C. Morgan, 62 percent of CEOs from companies which disclosed weaknesses left within 3 months of the disclosure, and that, in most cases, the disclosure triggers an investigation by the SEC).

remains to be seen whether plaintiffs could prove that a strong inference of scienter may be found from the record if the financial statements were the object of an unqualified opinion and the auditor still issued a material weakness opinion as to the Internal Control Over Financial Reporting. Then, if the auditor either issued a significant deficiency or issued an unqualified opinion under Section 404(b), the court would move to the second step in the analysis.[251]

In the second step, the court would need objective criteria to determine whether "the accounting practices were so deficient that the audit amounted to no audit at all, an egregious refusal to see the obvious or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts."[252] To comply with the *Tellabs* objective analysis requirement and using a unified approach using prior case law, courts would need to consider several factors in evaluating the various inferences presented by the plaintiff investor and the defendant auditor. However, in order to comply with *Tellabs*, the court will need to conclude "whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard."[253] In addition, when reviewing these factors, the aggregation of these factors would have to comply with the *Tellabs* requirement of concluding that "the inference of scienter must be more than merely 'reasonable' or 'permissible' — it must be cogent and compelling, thus strong in light of other explanations."[254] To that end, courts will need the consider the following: (1) whether the auditor violated GAAP or GAAS;[255] (2) whether the GAAP/GAAS violations were of significant magnitude in the aggregate of all the violations which were pled in the complaint, i.e. whether the impact of the violations, the alleged fraud or of the misstatements or improprieties were material, or whether the violations were not so egregious that their impact was not material;[256] (3) whether the auditor was on notice of the alleged violations, fraudulent accounting, fraud misstatements or improprieties; (4) whether other red flags were suspicious enough that an auditor would exercise sufficient due diligence to investigate whether material misstatements or omissions may exist which would impact the financial statements;[257] (5) whether the alleged red flags that were ignored were of significant

251. *See* Acevedo, *supra* note 53, at 31 n.182 (discussing the issuing of an unqualified opinion, which is the highest level or assurance that an auditor can give on an organization's financial statement); *supra* notes 191–92 and accompanying text. Assuming that only public information would be attached to the complaint, only a material weakness disclosure would be known to the plaintiff, as the stay on discovery would prevent him from uncovering the significant deficiency documentation. *See* 15 U.S.C §§ 77z-1(b), 78u-4(b)(3)(B) (2012).

252. SEC v. Price Waterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992) (citations omitted).

253. Tellabs v. Makor, 551 U.S. 308, 323 (2007).

254. *Id.* at 324.

255. *See supra* note 218 and accompanying text.

256. *See supra* note 219 and accompanying text.

257. *See supra* note 220–21 and accompanying text.

magnitude in the aggregate of all the red flags which were pled in the complaint, or whether these red flags merely constituted inconclusive or circumstantial violations;[258] (6) to what degree the auditor was on notice of those ignored "red flags" alleged in the complaint, and ignored these "red flags," and in doing so, violated PCAOB standards requiring them to exercise due professional care and professional skepticism in their performance of their audit work, or whether the auditor was unaware of either their existence or their magnitude; and (7) to what degree the auditor was aware of violation of internal policies or control procedures.

At this stage, the Section 404(b) certification by the auditor should have been incorporated in the complaint to strengthen an inference of knowledge and notice by the auditor. This will require the court to determine whether the Section 404(b) certification constitutes a strong inference of knowledge of factors (3) through (7), since the certification to the effectiveness of internal controls over financial reporting means that the auditor certifies that he had knowledge of the issuer's internal controls and if any material shortcomings in these internal controls had any impact on the veracity of the financial statements.

To comply with the *Tellabs* objective test requirement, the former analysis of motive and opportunity would no longer be considered as a relevant factor.[259]

In the third step where the court would apply these factors to the case at bar, the court would distinguish three situations in order to apply these factors to either distinguish or analogize prior case law. The first situation would involve claims where few of the above factors would be present simultaneously,[260] or where the alleged red flags would lack significant impact or would not rise to the level of indicia of suspicious accounting practices or improprieties, or would merely constitute inconclusive or circumstantial violations,[261] or where the plaintiff's claim would constitute no more than second guessing an audit process which was accomplished according to proper GAAS procedures.[262] In these cases, the Section 404(b) certification and the presence of a notice of significant deficiency or material weakness would have no impact because the plaintiff would have failed to plead a strong inference of scienter.[263]

At the other extreme,[264] the plaintiff would have been able to show significant GAAP and GAAS violations, and that "the magnitude of the misstatements, . . .the lack of internal controls in [several] problem areas, . . .the number of restatements,

258. *See supra* note 224 and accompanying text.

259. *See supra* note 245 and accompanying text.

260. *See infra* Appendix 3, Group I.

261. *See supra* note 224 and accompanying text.

262. *See* supra note 225 and accompanying text.

263. At that level of disconnect, the evidence weaknesses probably undercut any primary liability theory asserted by the plaintiff investor, in which case *Central Bank of Denver* would apply. *See supra* notes 111–112 and accompanying text.

264. *See infra* Appendix 3, Group III.

the specific GAAP and GAAS violations" which constituted, in the aggregate "an extreme departure from standards of ordinary care in a manner that was not significantly undermined by any purported disclosure by" the auditor.[265] Circumstances such as poor auditing processes which prevented the auditor to honor its "obligation to review and evaluate those records in order to form an opinion regarding. . . financial statements" or to discover a "lack of documentation and the fraudulent accounting treatment" may also contribute to a strong inference of scienter because a proper audit process "would have discovered if it had taken those steps."[266] In such cases, the Section 404(b) certification combined with the absence of a notice of significant deficiency or material weakness would essentially strengthen a strong inference of knowledge by the auditor of the failure in the control processes that led to fraudulent or improper accounting supporting a fraud. In such a case, the Section 404(b) certification would be additional support to the finding of a strong inference of scienter.

Between these two extremes lay a series of cases with specific characteristics.[267] Often, a complaint will claim significant GAAP violations by the auditor, along with a clear disregard of significant "red flags," such as accounting irregularities impacting specific business items having a critical impact on the business of the issuer, and the lack of internal controls associated with these items.[268]

In these cases, usually because of the PSLRA's stay on discovery requirement, the plaintiff's complaint is unable to allege specific facts pointing to the actual auditor's knowledge of the extent of the accounting improprieties, or how intimate the auditor was with the issuer management controls.[269] In these cases, the courts usually conclude that "it is not sufficient for a plaintiff to state that because a defendant violated GAAP, the defendant knew or must have known that it was publishing materially false information. Such a violation, on its own, does not

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265. *In re* Hamilton Bankcorp., Inc. Sec. Litig., 194 F. Supp. 2d 1353, 1359 (S.D. Fla. 2002).

266. *In re* Worldcom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2003 U.S. Dist. LEXIS 10863, at *22 (S.D.N.Y. June 25, 2003).

267. *See infra* Appendix 3, Group II.

268. *See In re* Cardinal Health Sec. Litig., 426 F. Supp. 2d 688, 702–09 (S.D. Ohio 2006) (alleging in a complaint that the scienter requirement was satisfied when the defendants' ignored numerous "red flags" and committed GAAP violations); *In re* Sunterra Corp. Sec. Litig., 199 F. Supp. 2d 1308, 1333 (M.D. Fla. 2002) ("Plaintiffs contend that they have adequately alleged scienter on the part of Arthur Andersen based on (1) the magnitude of the GAAP violations by Sunterra; (2) Arthur Andersen's awareness of the requirement that it comply with GAAS in conducting its audit; and (3) Arthur Andersen's alleged disregard of 'red flags.'").

269. *See Sunterra*, 199 F. Supp. 2d at 1333, 1337 (holding that the plaintiffs had failed to show specific allegations of knowledge where the plaintiffs alleged "that the Arthur Andersen representative failed to disclose at the shareholders' meeting Sunterra's failure to keep books in accordance with 'SEC rules [requiring it] to . . . maintain a system of internal accounting controls sufficient to reasonably assure, among other things, that transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP'").

represent the extreme departure from the standards of ordinary care that the recklessness standard requires."[270] However,

> *"if such dereliction of responsibility is accompanied by other 'red flags' which the auditor chooses to ignore, there may be enough to establish scienter. 'Red flags' are those facts which come to the attention of an auditor which would place a reasonable auditor on notice that the audited company was engaged in wrongdoing to the detriment of its investors. . . Whether scienter is sufficiently alleged may depend on the scope and severity of the auditor's failure to pay heed to 'red flags.'"*[271]

Hence, in this group of cases, "the heart of the issue as to the adequacy of the claim pled against [the auditor] concerns whether there were sufficient 'red flags' to put the auditor on notice that [the issuer] was engaged in wrongdoing to the detriment of its shareholders."[272] To resolve this issue, courts clearly struggle to pierce through the complaint to find out whether the specific facts alleged do raise an inference of the auditor being on notice of the accounting malfeasance, usually by observing the type and magnitude of the accounting errors.[273] Therefore, courts recognize that, although GAAP "violations alone are insufficient" to establish a strong inference of scienter, such "GAAP and GAAS violations accompanied by ignorance of 'red flags' could be sufficient to state a claim for securities fraud against an independent accountant,"[274] but in the absence of a stronger inference of knowledge by the auditor, the other allegations "fall short of tilting the scales in favor of a finding of a strong inference of severe recklessness."[275]

As it relates to the Section 404(b) certification, courts have already understood its impact on the inference analysis as it relates to the insider defendant who approves the financial statements. At least one court has held that "a Sarbanes-Oxley certification is only probative of scienter if the person signing the certification was severely reckless in certifying the accuracy of the financial statements. This requirement is satisfied if the person signing the certification had reason to know, or should have suspected, due to the presence of glaring accounting irregularities or other 'red flags,' that the financial statements contained material misstatements or

270. *See id.* at 1333 (quoting Malin v. Ivax Corp., 17 F. Supp. 2d 1345, 1361 (S.D. Fla. 1998)).

271. *Id.* at 1333–34; *see also* Van De Velde v. Coopers & Lybrand, 899 F. Supp. 731, 735–36 (D. Mass. 1995) ("A complaint will usually survive a motion to dismiss if plaintiffs have alleged the existence of 'red flags' sufficiently attention-grabbing to have alerted a reasonable auditor to the audited company's shenanigans.").

272. *Sunterra*, 199 F. Supp. 2d at 1334.

273. *See* cases cited *supra* note 218.

274. *See* Cheney v. Cyberguard Corp., No. 98–6879–CIV–GOLD, 2000 WL 1140306, at *11 (S.D. Fla. July 31, 2000).

275. *In re* Sunterra Corp. Sec. Litig., 199 F. Supp. 2d 1308, 1338 (M.D. Fla. 2002).

omissions."[276] As the *Tellabs* court did not specify, there should be no difference in the scienter analysis between an insider and an auditor, to the extent that an inference of knowledge can be construed from a Sarbanes-Oxley certification. The certifications by the insider officers and by the auditor provide that both parties affirmatively state that they investigated the control process and procedures of the entity, as well as the effectiveness of the management controls of the entity and they are therefore comfortable that such controls allow all material aspect of the financial statements to be accurate. Because both the insider officers[277] and the auditors[278] certify to these affirmative statements, a similar inference of knowledge will be drawn by the court. Consequently, in the case of the auditor, the Section 404(b) certification is likely to "tilt[] the scales in favor of a finding of a strong inference of severe recklessness."[279]

Although the threshold requirements to establish a strong inference of scienter or recklessness under *Tellabs* are likely to generate significant litigation in the future, this analytical framework will help reconcile the impact of the Section 404(b) certification with the PSLRA pleading requirement of scienter.

VI. CONCLUSION

Under *Tellabs v. Makor*,[280] federal circuit courts will need to reconcile their mandate for strict enforcement of the PSLRA pleading requirements with the critical goal of the Sarbanes-Oxley Act of increased disclosure and adherence to enhanced auditing professional standards. By implementing a consistent approach, which incorporates the framework of Auditing Standard No.5 and the PCAOB administrative case law, federal courts will ensure that they properly balance the need to triage frivolous section 10(b) suits from meritorious securities fraud claims against public accounting firms. This change will ensure that the federal courts strengthen their roles as a litigation watchdog, and as the pilot who "has guided the fate of vessels on the seas," will possess "the knowledge and skill necessary to navigate through storms and treacherous waters" of litigation.[281]

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276. Garfield v. NDC Health Corp., 466 F.3d 1255, 1266 (11th Cir. 2006).

277. Section 404(a) of the Sarbanes-Oxley Act states that management is required to produce an "internal control report" as part of each 10K Annual Report, which must attest to "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting." Sarbanes-Oxley Act of 2002 § 404(a), 15 U.S.C. § 7262(a) (2012).

278. Under Section 404(b) of the Sarbanes-Oxley Act, external auditors are required to issue an opinion on whether effective internal control over financial reporting was maintained in all material respects by management. 15 U.S.C. § 7262(b) (2012). This is in addition to the financial statement opinion regarding the accuracy of the financial statements. 15 U.S.C. § 7262(b) (2012).

279. *Sunterra*, 199 F. Supp. 2d at 1338.

280. 551 U.S. 308 (2007).

281. *See* Robert Edward Guidry, *The Seamen Who Have Walked the Plank on Statutory Negligence Remedies: The Pilot's Dilemma*, 1 LOY. MAR. L.J. 117, 117 (2002).

APPENDIX 1: TABLE OF FEDERAL 10(b) CLAIMS CASES

Name	Year	Circuit	Auditor	Scienter Analysis	Claim against Auditor	Facts	Outcome Auditor	Auditor Wins/Lose	Outcome Post Tellabs	Net Change
In Re Hamilton BankCorp Sec Liti	2002	Southern DC	Deloitte	GAAP violations, control weakness, red flags, magnitude, scope	Deloitte, Hamilton's	Hamilton **[**1**	***MD denied***	***Loses***	***Loses***	
Teachers Ret. Of LA v. ACLN (PW	2003	Southern DC	BDO Seidn	GAAS violations, no reporting, reckless procedures, conflict of interest	BDO International B	de-listing by N	***MD denied***	***Loses***	***Loses***	
In Re Lernout & Hauspie	2002	Mass	KPMG	Revenue recognition, false statements, red flags, misconduct, lack of internal controls	KPMG Singapore, E	2000 bankru	***MD denied (U***	***Loses***	***Loses***	
In Re Sunbeam Sec. Litigation	1999	Southern FLA	Andersen	GAAP/GAAS violations, on notice of fraudulent accounting, magnitude, internal controls	-- it elected not to ex	restructuring	***MD denied***	***Loses***	***Loses***	
In Re Rent-Way Securities Litigati	2002	Western PA	PWC	GAAP violations, control, red flags, magnitude	GAAP, red glags, co	**Plaintiffs' ot**	***MD denied***	***Loses***	***Loses***	
Whalen v. Hibernia Foods	2005	Southern DC	PWC	GAAP violations, reckless disregard to risk factors, red flags, on notice of fraudulent accounting, motive	PwC knew or recklessly disregarc		***MD denied***	***Loses***	***Loses***	
In Re Worldcom Securities Litig	2003	Southern Dist	Andersen	GAAP violations, magnitude, on notice of fraudulent accounting, absence of controls		**Taken as a w**	***MD denied***	***Loses***	***Loses***	
Arnlund v. Deloitte & Touche	2002	Southern VA	Deloitte	Material uncertainty, knowledge of imminent bankruptcy, knowledge of liquidity problems	It is alleged in the Amended Com		***MD denied***	***Loses***	***Loses***	
In Re Cardinal Health	2006	Southern DC	E&Y	GAAP/GAAS violations, improper practices, red flags BUT no evidence auditor knew or of misconduct		violation of §§	**MD granted**	**Wins**	**Loses**	**Loses**
Garfield v NDC	2006	11th	E&Y	GAAP/GAAS violations, red flags, BUT SOX not probative.			**MD granted**	**Wins**	**Loses**	**Loses**
In Re SunTerra Corp Sec Litigatio	2002	Central FL	Andersen	GAAP violations, material misstatements, red flags, improper accounting practices: (1) the magnitude of the GAAP violations by Sunterra; (2) Arthur Andersen's awareness of the requirement that it comply with GAAS in conducting its audit; and (3) Arthur Andersen's alleged disregard of "red flags," BUT whether there were sufficient "red flags" to put the auditor on notice that Sunterra was engaged in wrongdoing to the detriment of its shareholders. NO. Just negligence.	whether there were	Chapter 11 ba	**MD granted**	**Wins**	**Loses**	**Loses**
In Re Faro Technologies Securitie	2007	Central FL	Grant Thor	GAAP violations, improper accounting practices, red flags, lack of internal controls BUT circumstancial.	the existence of scie	restatement,	**MD granted**	**Wins**	**?**	**?**
PR Diamonds v. Chandler	2004	6th	Andersen	GAAP violations, improper practices, control deficiencies, red flags BUT less egregious in nature and magnitude (These alleged accounting and reporting problems do not resemble the pervasive and egregious manipulations found to support a strong inference of scienter in other cases)			**MD granted**	**Wins**	**?**	**?**
In Re Polaroid Corp Sec. Litigatio	2006	Southern DC	KPMG	Refinancing misopinion, lack of thoroughness, but it does not, without more, demonstrate recklessness. No knowledge issue.	Deferred Tax Asset	Polaroid's "ac	**MD granted**	**Wins**	**Wins**	
In Re Bally Total Fitness Sec Litig	2006	Northern DC	E&Y	12 red flags, BUT insufficient.	unqualified opinions	GAAP violati	**MD granted**	**Wins**	**Wins**	
In Re Ikon Office Solutions	2002	ED PA	E&Y	control weaknesses, red flags BUT mere second-guessing of calculations insuficient	Statement overestia	Reckless in fa	**MD granted**	**Wins**	**Wins**	

APPENDIX 2: TABLE OF PCAOB ENFORCEMENT CASES

Name	Cite	Year	Defendant	Facts	Holding
In the Matter of Willams & Webster	PCAOB Release No. 105-2007-001	2007	Williams, Webester, CP	Violation of § 150.02, Generally Accepted Audit	Firm censured, temporary barred
In the Matter of Benson	PCAOB Release NO.1 05-2007 -002	2007	Benson	Audit of Conversion Solution Holdings Corp. Int	Person Barred, registration revoked
In the Matter of Clyde Bailey	PCAOB Release No. 2005-021	2005	Bailey	Audit of Endevco, related parties txs, revenue r	Person Barred, registration revoked
In the Matter of Armando C. Ibarra, P.C.,	PCAOB Release No. 2006-009	2006	Ibarra	Audit of Triad, 600% overstatement. Audit of Na	temporary barred, registration revoked
In the Matter of Kenny H. Lee CPA Group	PCAOB Release No. 2005-022	2005	Lee	Audit of GSL Holdings,	Person Barred, registration revoked
In the Matter of Turner Stone & Company	PCAOB Release No. 2006-010	2006	Turner	Audit of 21st century, Bel Air, HCIA	Firm censured, temporary barred

APPENDIX 3: SUMMARY TABLE OF CASE SEGMENTATION

Inference Thresholds against the auditor	No Adverse Opinion	Significant Deficiency	Material Weakness
GROUP I **Circumstancial inferences** **Claims: GAAP violations, weak read flags, second guessing** **Cases: Bally, Ikon, Polaroid**	Motion granted	Motion granted	Motion granted
GROUP II **Stronger than circumstancial inferences without indicia of knowledge** **Claims: GAAP Violations, red flags, accounting impropr.** **Cases: Sunterra, Garfield, Cardinal**	***MOTION DENIED*** *(If magnitude present)*	***MOTION DENIED*** *(If magnitude present)*	Motion granted
Group III **Strong inferences of scienter with evidence of knowledge** **Claims: GAAP Violations, red flags, accounting impropr., control weaknesses, magnitude.** **Cases: Worldcom, Sunbeam, Hamilton**	**MOTION DENIED**	**MOTION DENIED**	***Motion granted***

Note: Motion granted=Motion to Dismiss the 10(b) claim against Defendant Auditor granted.
Note: MOTION DENIED=Motion to Dismiss the 10(b) claim against Defendant Auditor denied.
Note: italics areas cover cases which would come out differently post-Tellabs under section 404(b), compared to prior to Tellabs.