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2 Cases Audit Firm Defendants Can Rely On

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In opinions issued on the same day, federal appellate courts for the Second Circuit and the Eleventh Circuit both recently affirmed dismissals of securities fraud claims filed against independent audit firms that audited Chinese reverse-merger companies[1] because the plaintiffs did not adequately plead scienter under the heightened pleading standard imposed by the Private Securities Litigation Reform Act of 1995.[2] Under the PSLRA, plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind" with respect to each act or omission of the defendant that is alleged to violate the securities laws.

The Second Circuit's opinion in In re Advanced Battery Technologies Inc.[3] and the Eleventh Circuit's opinion in Brophy v. Jiangbo Pharmaceuticals Inc.[4] both held that to allege scienter on a recklessness theory against an independent audit firm under Section 10(b) of the Securities Exchange Act of 1934[5] and Rule 10b-5,[6] a plaintiff must allege facts showing that the audit firm's auditing practices were so deficient as to amount to "no audit at all" or that the audit firm disregarded signs of fraud that were "so obvious" that the audit firm must have been aware of them. In Brophy, the Eleventh Circuit adopted the "no audit at all" standard for the first time; in Advanced Battery, the Second Circuit adopted the "no audit at all" test for the first time in a published opinion.

Advanced Battery is significant in its own right because it is the first federal appellate case to expressly reject scienter arguments based on the alleged discrepancy between a company's filings with the U.S. Securities and Exchange Commission and with China's State Administration of Industry and Commerce, a regulatory agency to which Chinese companies must submit financial statements as part of an annual examination.[7]

Taken together, the decisions in Advanced Battery and Brophy reflect a growing trend: courts rejecting securities fraud claims filed against independent audit firms in the context of Chinese reverse-merger companies.[8] For example, in In re Puda Coal Securities Inc. Litigation,[9] the U.S. District Court for the Southern District of New York granted summary judgment in favor of an independent audit firm on a Section 10(b) claim under the "no audit at all" standard.

Second Circuit: In re Advanced Battery Technologies Inc.

In Advanced Battery, the plaintiff moved for leave to file an amended complaint after dismissal of the previous complaint for failure to adequately plead scienter. In the proposed amended complaint, the plaintiff alleged that the two defendant audit firms that audited the financial statements of Advanced Battery Technologies Inc. — a Delaware corporation with primary operations and subsidiaries in China — falsely represented that they performed their audits in accordance with professional standards and that ABAT's financial statements were fairly presented.

Among other things, the proposed amended complaint alleged that the audit firms were reckless and committed an "extreme departure from the reasonable standards of care" by failing to identify several purported "red flags," including: (1) conflicts between ABAT's financial statements filed with China's AIC and with the SEC; and (2) the unreasonably high profits that ABAT reported in its SEC filings, in contrast to the significant losses that it reported in its AIC filings. The district court denied leave to amend, and the Second Circuit affirmed.

The Second Circuit agreed with the district court that the proposed amended complaint, like the previous complaint, failed to adequately plead the audit firms' scienter under the theory of recklessness and that amendment would be futile. The appellate court explained that the plaintiff was required to allege conduct "that is highly unreasonable, representing an extreme departure from the standards of ordinary care," such that the conduct "must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company as, for example, when a defendant conducts an audit so deficient as to amount to no audit at all, or disregards signs of fraud so obvious that the defendant must have been aware of them."

Much of the Second Circuit's analysis focused on the plaintiff's argument that the audit firms acted recklessly by failing to inquire about or review ABAT's financial filings with China's AIC. In rejecting these arguments, the court noted that none of the "standards on which [the lead plaintiff] relies — the Generally Accepted Auditing Standards, Statements on Auditing Standards, or GAAP [generally accepted accounting principles] — specifically requires an auditor to inquire about or review a company's foreign regulatory filings."

The court declined to adopt the general rule, urged by the plaintiff, that allegations of an audit firm's failure to inquire about or review such foreign filings are adequate to plead recklessness under the PSLRA. Although the court noted that "such a legal duty could arise under certain circumstances" (which it did not explain), it concluded that those circumstances were not pled here.

In addition, the Second Circuit held that ABAT's report of high profit margins in its SEC filings triggered, at most, a duty to perform a more rigorous audit of those filings, not of the company's AIC filings. The court declined to infer recklessness from the allegations that one of the audit firms had access to, and "presumably relied" on, the financial data underlying ABAT's AIC filings but failed to see that the data contradicted the company's SEC filings. Instead, the court found another inference more compelling — that ABAT maintained different sets of data for its Chinese and U.S. regulators and provided the audit firm with false data.

Eleventh Circuit: Brophy v. Jiangbo Pharmaceuticals Inc.

In Brophy, the plaintiff-investors had alleged, among other things, that the former chief financial officer

and the independent auditor of Jiangbo Pharmaceuticals — a company with China operations that became public through a reverse merger with a U.S. shell company — misrepresented the company's cash balances and failed to disclose a material related-party transaction in Jiangbo's public filings with the SEC. The district court granted the CFO's and the audit firm's motions to dismiss, holding that the complaint did not sufficiently plead scienter, and entering final judgment as to both the CFO and the audit firm. The court entered judgment against those defendants under Rule 54(b), and the plaintiffs appealed.

In affirming the district court's ruling, the Eleventh Circuit explicitly adopted the standard applied by the district court for evaluating an inference of scienter as to an independent audit firm: "[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 which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts."

Applying this "no audit at all" standard, and having already concluded that the plaintiffs' allegations against the CFO and her oversight of several purported "red flags" failed to achieve more than a tenuous inference of scienter, the Eleventh Circuit concluded that the corresponding inference against the audit firm was even more attenuated. As an external auditor, the court determined, the audit firm was "a step more removed" than the CFO from any alleged indicators of the fraud. Ultimately, the court concluded, the plaintiffs' allegations against the audit firm, like their allegations against the CFO, "failed to articulate a theory of the fraud with any particularity."

The court pointed out that the complaint did not (1) identify the ways in which the audit was deficient; (2) allege that the audit firm had extensive involvement with the company beyond what was required to conduct a single audit; or (3) allege facts sufficient to support a connection between the SEC's informal, nonpublic investigation of Jiangbo and the audit firm's state of mind. In light of these and other deficiencies, the court concluded that the complaint, at most, established negligence but not a "strong inference of scienter" under the "high bar" of the PSLRA's pleading standard.

Implications for Practitioners

These opinions are significant because they illustrate the high burden plaintiffs face in pleading recklessness in Section 10(b) cases against independent audit firms. Under these cases' holdings, plaintiffs filing suit within the Second Circuit and Eleventh Circuit must plead with particularity facts alleging that the audit firm's work was so deficient as to amount to "no audit at all." Practitioners representing audit firm defendants, therefore, should consider whether there is an early motion to dismiss to be made by relying on these cases.

Also, the Second Circuit's determination that allegations that an audit firm failed to review AIC filings is not sufficient to meet this high burden for pleading scienter is significant, as such allegations are frequently pled in matters involving audits of the financial statements of Chinese companies listed on U.S. securities exchanges. Consequently, practitioners should consider the applicability of these cases in securities litigation involving companies from other emerging markets besides China.

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[1] A common technique among Chinese companies for gaining access to U.S. capital markets without the burdens associated with traditional initial public offerings is to "reverse" merge with an existing publicly listed company in the United States.

[2] 15 U.S.C. § 78u-4(b)(2)(A).

[3] No. 14-1410-CV, — F.3d —, 2015 WL 1321233 (2d Cir. Mar. 25, 2015).

[4] No. 14-10213, — F.3d —, 2015 WL 1321524 (11th Cir. Mar. 25, 2015).

[5] 15 U.S.C. § 78j(b).

[6] 17 C.F.R. § 240.10b-5.

[7] District courts within the Second Circuit — but not the Second Circuit itself — have previously determined that discrepancies between SEC and AIC filings, in and of themselves, do not constitute a "red flag" that should have put an independent audit firm on notice of a company's fraud. See generally In re ShengdaTech Inc. Sec. Litig., 2014 WL 3928606, at *8 (S.D.N.Y. Aug. 12, 2014).

[8] See, e.g., Special Situations Fund III QP LP v. Deloitte Touche Tohmatsu CPA Ltd., 2014 WL 3605540 (S.D.N.Y. July 21, 2014); In re Puda Coal Securities Inc. Litig., 2014 WL 2915880 (S.D.N.Y. June 26, 2014); In re China Organic Sec. Litig., 2013 WL 5434637 (S.D.N.Y. Sept. 30, 2013).

[9] Mayer Brown LLP represented the independent audit firm defendant Moore Stephens Hong Kong in this case.
