An Auditor’s Scienter

*New Mexico State Investment Council v. Ernst & Young*

A company’s auditor is a vital guard against fraud. The auditor offers an opinion on whether management’s financial representations are fair and accurate based on the auditor’s independent testing of those representations. But bringing securities fraud suits against auditors has been made difficult by legislative reform and judicial decisions. In particular, as Professor John C. Coffee, Jr., recounts in *Gatekeepers: The Professions and Corporate Governance*, “the ‘strong inference of fraud’ pleading standard ... particularly protected the auditor defendant because at the outset of the case the plaintiffs typically possess little information about the auditor’s involvement. ... The upshot is a Catch 22-style dilemma: one cannot plead a ‘strong inference of fraud’ against the auditor until one has obtained discovery, and one cannot obtain discovery until one has pleaded a strong inference of fraud.”

To be liable under Section 10(b) and Rule 10b-5, auditors must act with deliberate recklessness. Alleging a “strong inference” of this mental state as required by the PSLRA is a heavy burden for plaintiffs. Plaintiffs must allege and prove that the accounting practices were so deficient that the audit amounted to no audit at all; or that the auditor egregiously refused to see the obvious, investigate the doubtful, or that the accounting judgments made would not have been made by a reasonable accountant. In *New Mexico State Investment Council v. Ernst & Young, LLP*, 641 F.3d 1089 (9th Cir. 2011), the Ninth Circuit recently discussed the standard for pleading scienter for a company’s outside auditor.

In that case, Broadcom and its officers allegedly backdated $2.2 billion in stock options for more than five years. Backdating options is not in and of itself improper under the securities laws or accounting
principles. But accounting principles do require that backdated options are recorded as an expense to the company and compensation to the recipient. The plaintiffs alleged that the company’s auditors knew or recklessly disregarded Broadcom’s fraudulent backdating scheme—the company was not accounting for the $2.2 billion in income—but issued clean audit opinions nonetheless. The plaintiffs alleged that the auditor acted with scienter primarily because the auditor (1) signed off on a $700 million charge to the company’s financial results without obtaining any documentation; and (2) knew that several significant option grants were approved when the company’s compensation committee was not legally constituted because one of the two members was dead. The district court dismissed the plaintiffs’ complaint, concluding that they had not alleged a strong inference of scienter. The Ninth Circuit reversed the decision and remanded the case.

According to the Ninth Circuit, the plaintiffs alleged with particularity a strong inference that the company’s auditor acted with scienter. First, the court held that the auditor’s signing off on the $700 million charge was indicative of scienter: it was the single largest grant of stock options in the company’s history, the potential $700 million impact on the company’s earnings was material as it was roughly a quarter of the company’s reported revenue, the grant came on the day that the price of the stock was the lowest in several months, and even though the auditor questioned the timing of the grant (as evidenced by e-mail conversations) the auditor never received or reviewed any documentation to verify that the option treatment was legitimate. Second, the court recognized that the fact that the auditor signed off on options issued when the audit committee was not legally constituted suggested a strong inference of scienter. The court emphasized that not only did the auditor first accept unsigned draft minutes approving the stock options, but the auditor later accepted draft minutes that were clearly false as they

“Backdating options is akin to betting on a horse race after the horse has already crossed the finish line. Backdating of options occurs when a company’s officers or directors responsible for administering the stock option plan monitor the price of the company stock and then award a stock option grant as of a certain date in the past when the share price was lowest, thus locking in the largest possible gain for the option recipient.” New Mexico State Investment Council v. Ernst & Young, LLP, 641 F.3d 1089, 1093 (9th Cir. 2011).
were signed and dated by the deceased committee member.

The Ninth Circuit’s decision is available here: