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Second Circuit Rejects Investor Suit Against Auditors, Adhering To High Standard for Alleging Scienter

Last week, the Second Circuit issued an opinion in *In re Advanced Battery Tech., Inc.*, No. 14-1410-cv, affirming the district court's denial of leave to amend a securities fraud complaint against auditors who allegedly failed to detect a corporate fraud at a Chinese battery manufacturer. The decision underscores the difficulty of alleging scienter in claims against auditors, and is likely to encourage district courts to closely scrutinize alleged "red flags" that plaintiffs contend should put a defendant (auditor or otherwise) on notice of an alleged fraud.

Background

According to plaintiff's allegations, Advanced Battery Technology, Inc. ("ABAT") is a Delaware corporation whose primary operations involve battery manufacturing in China. The company, which was listed on the NASDAQ, was required to file financial statements with both the SEC and China's State Administration of Industry and Commerce. (Op. 4.) These two sets of filings differed dramatically, with the SEC filings portraying a far more favorable view of the company's financial health. For instance, in 2007, its statements filed with the SEC showed over \$31 million in revenue and \$10 million in profits, while its statements filed in China showed revenues of \$145,000 and an operating loss of \$1 million for the same period. (Op. 4-5). Additionally, ABAT allegedly purchased a company without revealing that it was owned by ABAT's CEO (who had purchased it for a much lower price just two years earlier), and mischaracterized its beneficial interest in another company, stating that that company was a wholly owned subsidiary when it in fact was owned by ABAT's CEO and others. (Op. 5-6.) When the discrepancies between ABAT's U.S. and Chinese securities filings were revealed by third-party sources in 2011, ABAT's stock dropped by almost forty-eight percent. (Op. 9.)

The plaintiff asserted securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 against ABAT and certain of its executives, which were sustained against a motion to dismiss and subsequently settled. Plaintiff also brought claims against two auditing firms that had certified ABAT's financial statements during the relevant period, stating that they conformed with GAAP and fairly presented ABAT's financial position. The auditors' statements also represented that the audits themselves had been conducted "in accordance with the standards of the Public Company Accounting Oversight Board." (Op. 7.)

After the district court dismissed the claims against the auditors, the plaintiff moved for leave to file an amended complaint. The district court denied the motion on the grounds that it would be futile, because

the plaintiff's proposed amended complaint did not adequately allege scienter. The plaintiff appealed. (Op. 3.)

Decision

The Second Circuit affirmed, holding that permitting the proposed amended complaint would be futile because it did not adequately allege scienter against the auditors. The principal analysis in the opinion is the court's application of the standard set by the Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 511 U.S. 308, 219 (2007), which stated that in order for a securities fraud claim to succeed, the facts alleged in a complaint must give rise to a "strong inference" that the defendants acted with scienter, meaning that the inference of scienter must be "cogent and at least as compelling as any opposing inference one could draw from the facts alleged." The court "must consider plausible, nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiffs." *Id.*

The Second Circuit began its legal analysis by noting that of the two ways of alleging scienter—whether by showing "motive and opportunity," or by showing strong circumstantial evidence of conscious recklessness—the plaintiff here had pursued a recklessness approach. The court noted that where there was no allegation of motive, as here, the plaintiff's burden of proving recklessness through circumstantial allegations is "correspondingly higher." (Op. 11.) In addition, as the court observed, the standard for alleging scienter against an independent auditor in the Second Circuit was higher still: the conduct "must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company[.]" (Op. 11–12) (quoting *Rothman v. Gregor*, 220 F.3d 81, 98 (2d Cir. 2000)).

Applying this high standard, the Second Circuit agreed with the district court that the "red flags" alleged by the plaintiff—the difference between the American and Chinese filings, the related-party transaction, the mischaracterization of ownership, unusually high profit margins, and the use of a reverse merger to be listed on an American stock exchange—were either not alleged to have been seen by the auditors or not sufficient to alert the auditors to fraudulent conduct or to impose a duty to further inquire. (Op. 8, 17.) The court held that, at most, the proposed amended complaint alleged that the auditors were negligent, and failed to do sufficient diligence to uncover the alleged frauds—nothing more. (Op. 17.)

Notably, the court held that auditors are generally under no duty to inquire about or review a company's foreign regulatory filings in the course of auditing the U.S.-listed company, and that it was not reckless for the auditors not to have done so. (Op. 13.) In doing so, the court found insufficient the plaintiff's expert's conclusory statement that no reasonable auditor would have failed to obtain the Chinese filings. (Op. 13.) The court stated that the alleged red flags would at most trigger a duty to perform a more rigorous audit of the filings they were reviewing, rather than to look at the Chinese filings. (Op. 14.)

The complaint also alleged that the auditors must have had access to the raw financial data underlying ABAT's Chinese filings, but failed to see that it contradicted the SEC filings. The court disagreed,

reasoning that the more compelling inference from the fact of the contradictory filings was the hypothesis that ABAT kept two sets of data and gave the auditor false data that supported its SEC filings. (Op. 15.)

In response to the allegation that the Chinese company's use of a reverse merger to gain access to American capital markets should have been a red flag, the court noted that the conduct occurred before mid-2011—before heightened scrutiny began to be applied to Chinese companies involved in reverse mergers (at least as alleged in the complaint). (Op. 14.)

Analysis

The Second Circuit's decision confirms the high bar set for plaintiffs attempting to bring securities fraud claims against auditors. Given the absence of a plausible motive for auditors knowingly to certify false financial statements—putting their own reputations at risk for a modest gain at best—the Second Circuit has taken a relatively narrow view of the duties owed by auditors. So, at least when evaluating claims against auditors, underwriters, and others who provide services to a public company, the opinion suggests that district courts should greet circumstantial allegations of recklessness, like those asserted here, with great skepticism. Specifically, it implies that courts should look to relevant industry standards to determine if those standards impose a duty to conduct a particular kind of inquiry, and decline to infer recklessness where they find that the defendant breached no such duty, as the court did here with respect to the auditors' failure to investigate ABAT's foreign filings.

The opinion raises the further question, however, of whether this heightened skepticism will extend to claims against the issuer and its senior management and outside directors, as well. Complaints in section 10(b) actions commonly rely on purported “red flags” as the basis for scienter allegations. This decision will also likely encourage district courts to undertake a more critical examination of the “red flags” asserted in support of a recklessness theory, not only when the claim is levelled against auditors and underwriters, but in evaluating claims against the issuer and its management, as well. To the extent that the court's holding directs district courts to scrutinize more carefully whether the facts constituting the red flags were actually known to the defendants, the opinion does not break new ground. But it is significant that the decision turned at least in part on whether Chinese companies that effected a reverse merger to go public in the United States were widely perceived to be securities fraud risks before mid-2011, suggesting that after that date, auditors, underwriters and other defendants would be expected to be more sensitive to the possibility of fraud in such companies. On this reading, the opinion seems to indicate that allegations that all defendants should have been aware of “red flags” must be evaluated in an industry-wide context.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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