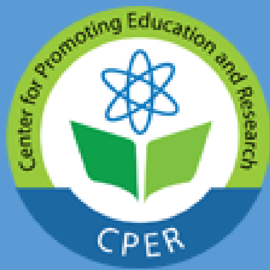
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Auditors' Liability for Failure to Detect Fraud: Lessons Learned from Recent American Case Law

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ABSTRACT

Auditors are occasionally sued for their failure to detect fraud in the client firm during an audit. These lawsuits are typically grounded in professional negligence, negligent misrepresentation, fraud, aiding and abetting fraud, or federal securities fraud. The PCAOB recently promulgated AS 2401, "Consideration of Fraud in a Financial Statement Audit," which contains fraud-related Generally Accepted Auditing Standards (GAAS) applicable to audits of publicly-traded entities. An auditor's failure to comply with GAAS may be evidence of professional negligence. U.S. states are divided as to whether an auditor's averment of compliance with GAAS in an audit report is a statement of opinion or a statement of fact. An auditor's failure to investigate evidence indicating potential fraud is one factor used to determine an auditor's legal liability. An auditor may be able to use the doctrine of in pari delicto *as a defense if the plaintiff is also a wrongdoer.*

Keywords: financial, statement, audit, fraud, detection

Objectives of the Paper

The objectives of this paper are to:

1. Cover the common law and statutory sources of auditor liability for failure to detect fraud;
2. Highlight the Generally Accepted Auditing Standards that are most relevant to fraud detection;
3. Note the "red flags" recognized in the American case law as potential indicators of fraud for auditors;
4. Tell when auditors may be able to apply the *in pari delicto* defense if they have been sued for failing to detect fraud;
5. Present representative legal cases where auditors were held liable after failing to detect fraud, and representative legal cases where auditors alleged to have failed to detect fraud were not held liable; and
6. Draw conclusions from all of the above.

Common-Law and Statutory Sources of Auditor Liability

Auditors are occasionally sued for their failure to detect fraud in the client firm during an audit. These lawsuits are typically grounded in professional negligence, negligent misrepresentation, fraud, aiding and abetting fraud, or federal securities fraud.

Professional Negligence

This is one species of negligence. A negligence claim requires the plaintiff to establish: (1) a the duty owed to the plaintiff or to a class of which the plaintiff is a member; (2) a breach of that duty; (3) a causal relationship between the breach of the duty and the harm incurred by the plaintiff; and (4) damages suffered.[1] Specifically, therefore, Professional Negligence requires a plaintiff to show that: (1) plaintiff contracted for the service, or the service ordinarily would be performed in the course of the professional performing its obligations under a contract; (2) defendant's professional services departed from the accepted standards of practice in the relevant field; and (3) the departure proximately caused the plaintiff's injuries.[2]

When Does an Auditor Have a Duty to Investors and Shareholders of the Audited Company to Provide Accurate Information? If there is no contract between the auditor and the user of the financial information, then a close relationship of near-privity is required.[3] The test for near-privity was created by the New York Court of Appeals and requires three elements: (1) the auditor must have been aware that the information would be used for a particular purpose; (2) in furtherance of which a known party was intended to rely on; and (3) some conduct by the auditor linking him to that known party.[4] If there is no privity or near-privity between the auditor and the user, the case must be dismissed.[5]

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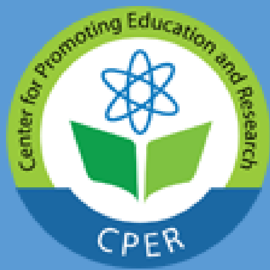
[1] Malinowski v. Lichter Grp., LLC, 165 F.Supp.3d 328, 340 (D. Md. 2015).
[2] Wax NJ-2, LLC v. JFB Constr. & Dev., 111 F. Supp. 3d 434, 447 (S.D.N.Y. 2015).
[3] In re Kingate Mgmt. Ltd. Litig., 2016 U.S. Dist. LEXIS 129882 (S.D.N.Y. 2016).
[4] Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d 110 (N.Y. 1985). Some states have adopted this test in a statute. See, e.g, Pasqua v. Cnty. Of Hunterdon, 2016 U.S. Dist. LEXIS 106143 (D. N.J. 2016), citing the New Jersey Accountant Liability Act, NJ Rev. Stat. § 2A: 53A-25 (2013). Some states have enacted regulatory requirements; e.g., in Louisiana, no suit may be filed against a CPA until after the claim has been reviewed by the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Proving Causation. When a plaintiff claims she has suffered loss by entering into a transaction as a result of negligent advice from an auditor, the plaintiff must be able to show there is a reasonable probability or a reasonable certainty that the auditor's negligence caused her to enter into the transaction. Mere possibility is not enough.[6] If she cannot, her claim must fail. But even if she can, it is not sufficient for her to establish that the transaction caused her loss. She must still show what (if any) part of her loss is attributable to the auditor's negligence. This is usually treated as a question of the measure of damages rather than causation, but it must be acknowledged that it involves questions of causation.

The plaintiff need not allege the entire loss was caused by the financial statement misstatements and omissions complained of, only that plaintiff would have been spared all or an ascertainable portion of that loss.[7]

Negligent Misrepresentation

A plaintiff asserting a claim for negligent misrepresentation must prove that: (1) the defendant, owing to a duty of care to the plaintiff, negligently asserted a false statement; (2) the defendant intended that his statement would be acted upon by the plaintiff; (3) the defendant had knowledge that the plaintiff would probably rely on the statement which, if erroneous, would cause loss or injury; (4) the plaintiff took justifiable action in reliance on the statement; and (5) the plaintiff suffered damage proximately caused by the defendant's negligence.[8] Therefore, to assert a valid claim of negligent misrepresentation against an auditor, it is not enough that the audit report may have contained omissions or even misinformation; rather, the plaintiff must demonstrate that he read and relied on the report to his detriment. If a plaintiff were to admit that he had no recollection of obtaining, reading, or reviewing the audit report, that would almost certainly be fatal to his claim of negligent misrepresentation.[9]

Fraud

Common-Law Fraud. The elements are: (1) defendant made a material representation; (2) which was false; (3) which was known to be false when made or was made recklessly as a positive assertion without knowledge of its truth; (4) which was intended to be relied upon; (5) which was relied upon; and (6) which caused injury.[10]

A plaintiff would allege common law Fraud if she believed the auditor had intentionally or recklessly made a materially false statement or omission in an audit report, and the plaintiff relied upon that information to her detriment.

Statutory Fraud. The elements are: (1) defendant made a material representation; (2) which was false; (3) made to induce a person to enter a contract; (4) which was relied upon by that person in entering the contract; and (5) which caused an injury.[11] The only difference between common law and statutory fraud is that the latter does not require proof of knowledge or recklessness as a prerequisite to the recovery of damages.[12] A plaintiff would allege statutory fraud if he believed the auditor had negligently disseminated a materially false statement or omission in an audit report, and the plaintiff had relied upon that information to his detriment. Note that the requisite mental element in statutory fraud—negligence—is less stringent and easier to prove than the common law fraud requirement, which is recklessness or with intent.

Aiding and Abetting Fraud

Aiding and Abetting Fraud is occasionally used against an auditor for allegedly failing to detect a client's fraud.[13] To establish a claim that an auditor committed the tort of Aiding and Abetting Fraud, a plaintiff must show: (1) the existence of an underlying fraud in the client firm; (2) knowledge of this fraud on the part of the auditor; and (3) substantial assistance by the auditor in the achievement of the fraud.[14] This tort was pled against an auditor of a firm that engaged in a Ponzi scheme; the auditor helped to conceal the fraud over sixteen years but escaped liability due to the statute of limitations.[15]

Federal Securities Trading Law

Exchange Act § 10A(b). An accountant who becomes aware of a possible "illegal act" carried out by the client firm's officers, which by definition includes a materially false or misleading statement or the omission of material facts, must ensure that the client's audit committee is "adequately informed" of the illegal act unless the illegal act is "clearly inconsequential."[16]

Exchange Act § 10(b) and SEC Rule 10b-5. Section 10(b) makes it unlawful to use or employ, in connection with the purchase or sale of any security after the original offering, a
manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Securities and Exchange Commission (SEC) may prescribe.[17]

To bring an action under SEC Rule 10b-5, the purchaser/seller requirement mandates that a private plaintiff must be either a buyer or a seller of the company's stock. Potential buyers who were defrauded into not buying stock may not bring an action under 10b-5. To succeed on a Rule

state public accountant review panel and it has issued a written opinion. See, Firefighters' Ret. Sys. v. Grant Thornton LLP, 2017 U.S. Dist. LEXIS 37865 (M.D. La. 2017).

[5] See, e.g., Admin. Comm. of the Am. Excelsior Co. v. GreatBanc Trust Co., 2015 U.S. Dist. LEXIS 133160 (No. D. Tx., Ft. Worth 2015). A contractual disclaimer may be used by an auditor to avoid assuming a duty to every user or class of users. For example, if a client agrees in a contract that it will be solely responsible for prevention and detection of fraud, the auditor will avoid assuming that duty. Id.

[6] Casey v. Geek Squad Subsidiary Best Buy Stores, L.P., 823 F. Supp. 2d 334, 351 (D. Md. 2011).

[7] DoubleLine Capital LP v. Construtora Norberto Odebrecht, S.A., 413 F. Supp. 3d 187 (S.D.N.Y. 2019).

[8] Lloyd v. GMC, 916 A.2d 257, 273 (Md. 2007).

[9] Malinowski v. Lichter Grp., LLC, Note 1 at 338.

[10] Green Intern, Inc. v Solis, 951 S.W.2d 384, 390 (Tex. 1997).

[11] Tex. Bus. & Com. Code Ann. § 27.01 (Vernon 1987).

[12] Id. at 77.

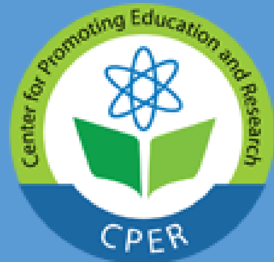
[13] Proof that an auditor has knowledge of a fraud and fails to disclose it is sufficient to prove the auditor aided and abetted management in carrying out the fraud. Woods v. Barnett Bank of Fort Lauderdale, 765 F.2d 1004, 1010-11 (11th Cir. 1985).

[14] Cupersmith v. Plaker & Lyons P.C., 2016 U.S. Dist. LEXIS 131849 (N.D.N.Y. 2016).

[15] Id.

[16] Barsa v. Theseus Strategy Grp. (In re Old Bpsush, Inc.), Case No. 16-12373 (BLS) (B.R. Del. 2020).

[17] Glickenhaus & Co. v. Household Int'l, Inc., 787 F.3d 408, 414 (7th Cir. 2015).



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10b-5 claim, the plaintiff must establish: (1) a material misrepresentation or omission by a defendant; (2) made with scienter;[18] (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission by plaintiff; (5) economic loss; and (6) loss causation.[19] If an auditor is issued for violation of Rule 10b-5, the plaintiff will often be a purchaser of the client firm's stock alleging that he relied upon erroneous information in the auditor's report when he decided to buy the stock and that he incurred detriment when the stock value decreased.

Exchange Act § 18. This provision provides for a private cause of action against any defendant making or causing to be made, false or misleading material facts in any application, report, or document filed with the SEC. The plaintiff must have relied upon the false or misleading material facts to its detriment.[20] A purchaser of the client firm's stock could file a § 18 action against an auditor due to erroneous information the auditor filed with the SEC.

Exchange Act § 20(a). This section provides for the "control person" liability of any person who, directly or indirectly, controls any person liable for violations of federal securities law.[21] The elements of control person liability are: (1) a primary violation of federal securities law; and (2) that the defendant exercised actual power or control over the primary violator. If there is no primary violation of federal securities law, there can be no control person liability.[22] If an auditor was a ringleader in a conspiracy with corporate officers or directors to defraud the corporation, then the auditor could be sued under
§ 20(a).

Securities Act § 17(a). This section prohibits fraud in the initial offering or sale of securities, using the mail or other instruments of interstate commerce. The defendant must have (1) made a misstatement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities.[23] Section 17(a) could be used to sue an auditor who had certified information in a corporate prospectus issued in an initial public offering of the corporation's securities.

Specific Auditor Responsibilities Pertaining to Fraud

Ordinarily, auditors do not give clients a warranty that they can prevent or detect fraud, only reasonable assurance. However, the Sarbanes-Oxley Act (SOX)[24] requirement for each publicly-traded firm to have an annual integrated audit[25] was enacted as a direct response[26] to the four "Arthur Andersen frauds."[27] SOX provided for the creation of the Public Company Accounting Oversight Board (PCAOB), responsible for the promulgation of General Accepted Audit Standards (GAAS) applicable to the integrated audits of all publicly-traded entities.[28]

An auditor may be legally liable if it fails to follow fraud-related aspects of GAAS (covered next) or ignores fraud risks in audit planning. Accordingly, an auditor is responsible for designing audit procedures to adequately address fraud risks and for obtaining sufficient evidence to support its audit opinion. It would be a mistake for an auditor to overly rely on management representations on fraud-related issues.[29]

GAAS Relating to Fraud: Highlights

The latest GAAS pertinent to fraud are contained in AS 2401, "Consideration of Fraud in a Financial Statement Audit."[30] These standards apply to audits of publicly-traded entities whose fiscal years end on or after December 15, 2020.[31] These are some of the most important points:

- Auditors have a responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement, *whether due to error or fraud*.[32] (Emphasis added.) Absolute assurance is unattainable, so there is no guarantee that even a thorough audit will uncover a fraud.[33]
- Notwithstanding the auditor's fraud responsibility, management is ultimately responsible for the design and implementation of programs and controls to prevent and detect fraud.[34]
- Fraud is defined as "an intentional act that results in a material misstatement in financial statements. . ."[35] Two types of misstatements are relevant to the consideration of fraud: those due to fraudulent financial reporting and those due to misappropriation of assets.[36]Management has a unique ability to perpetrate fraud because it frequently is in a position to

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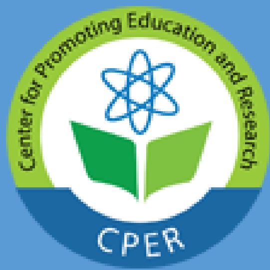
[18] Scienter requires "an intent to deceive or defraud or that severe recklessness in which the danger of misleading buyers or sellers is either known to the defendant or is so obvious that the defendant must have been aware of it." R2 Invs. LDC v. Phillips, 401 F.3d 638, 643 (5th Cir. 2005). Acknowledging or restating inaccurate financial statements does not in itself support a strong inference of scienter. Kohut v. KBR, Inc., 2015 U.S. Dist. LEXIS 189465 (S.D. Tx., Houston 2015). Restatements can arise from negligence, oversight or simple mismanagement, none of which rise to the standard necessary to support a securities fraud action. Abrams v. Baker Hughes, Inc., 292 F.3d 424, 433 (5th Cir. 2002).
[19] Cornielsen v. Infinium Capital Mgmt., LLC, 916 F.3d 589, 598 (7th Cir. 2019).
[20] In re Suprema Specialties, Inc. Sec. Litig., 438 F.3d 256, 283-84 (3d Cir. 2006).
[21] See, e.g., DoubleLine Capital LP v. Construora Norberto Odebrecht, S.A., Note 7 at 219-21.
[22] In re Cutera Sec. Litig., 610 F.3d 1103, 1113 n. 6 (9th Cir. 2010).
[23] SEC v. Sys. Software Assocs., Inc., 145 F. Supp. 2d 954, 957 (N.D. Ill. 2001).
[24] Sarbanes-Oxley Act, Pub. L. 107-204, 116 Stat. 745, 15 U.S. Code § 7201 et seq. (2002).
[25] Id. at § 404. An "integrated" audit is an evaluation of the client firm's financial statements as well as its internal controls. Id.
[26] R.I. Res. Recovery Corp. v. Monacelli, 2015 R.I. Super. LEXIS 17 (R.I. Super., Prov. 2015).
[27] Arthur Andersen, now defunct as a result, was the auditor in all four cases which led to the enactment of SOX: In re Enron Corporation Securities, Derivative & ERISA Litigation, 235 F.Supp.2d 549, 563 (S.D. Tex. Houston Div., 2002); *In re* Global Crossing, Ltd. Securities Litigation, 322 F.Supp.2d 319 (S.D.N.Y. 2004); *In re* WorldCom, Inc. Securities Litigation, 352 F.Supp. 2d 472, 482 (S.D.N.Y. 2005); and Alaska Electrical Pension Fund v. Adecco S.A., 371 F.Supp. 1203, 1207-08 (S.D.Cal. 2005).
[28] Id.
[29] FDIC v. Ernst & Young LLP, 2020 U.S. Dist. LEXIS 122153 (E.D. La. 2020).
[30] Public Company Accounting Oversight Board, "AS 2401: Consideration of Fraud in a Financial Statement Audit;" https://pcaobus.org/oversight/standards/auditing-standards/details/AS2401 . When performing an integrated audit of financial statements and internal control over financial reporting, an auditor should also comply with paragraphs .14-.15 of AS 2201, "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements;" https://pcaobus.org/oversight/standards/auditing-standards/details/AS2201 .These paragraphs mandate the auditor to take his fraud risk assessment into account when evaluating the client's internal controls. The auditor should ask himself whether the internal controls in place are sufficient to address the risk of material misstatement due to fraud and whether internal controls designed to prevent management override of other controls are sufficient. Controls that might address these risks include: controls over significant transactions made outside the normal course of business, controls over adjusting entries made at the end of the fiscal year, controls over related party transactions, controls related to significant management estimates, and controls that mitigate pressure on management to manipulate financial statements. Id.
[31] Id.
[32] AS 2401.01.
[33] AS 2401.12.
[34] AS 2401.04.
[35] AS 2401.05.
[36] AS 2401.06.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directly or indirectly manipulate accounting records and present fraudulent financial information.[37]

- Fraud is usually concealed,[38] but these conditions may be indicative of fraud: missing significant documents, subsidiary ledgers not reconciled to control accounts or unexpected results of analytical procedures.[39]
- An auditor should recognize the possibility that fraud may exist, despite a general belief that management is honest. The auditor should be professionally skeptical and have an ongoing questioning of whether evidence gathered during the audit is indicative of fraud.[40]
- The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each relevant account and disclosure.[41]
- Audit procedures relating to fraud include: surprise inventory counts or cash counts, counting inventories at or near the end of the fiscal year, making oral inquiries of customers and suppliers in addition to written confirmations, performing substantive analytical procedures using disaggregated data, interviewing personnel working in locations with heightened fraud risk,[42] and overseeing the fraud-related work of auditors in other subsidiaries, branches or divisions of the firm being audited.[43]
- The audit procedures performed in response to a fraud risk relating to the misappropriation of assets will be directed toward those assets that are most susceptible to misappropriation.[44]
- Audit procedures should also be developed to address the risk of management override of internal controls. These include the examination of journal entries for any evidence of material misstatement due to fraud;[45] reviewing accounting estimates for biases that could result in material misstatement due to fraud;[46] and evaluating whether the business purpose for significant unusual transactions indicates those transactions may have been entered into as part of a fraud scheme.[47]
- The auditor is responsible for communicating about possible fraud to management, the audit committee, the Securities and Exchange Commission, and others.[48]
- Finally, the auditor has to document all of the evidence uncovered pertinent to fraud.[49]

Whether the Auditor Complied with GAAS: Opinion or Fact?

Some American courts have held that an auditor's averment in the audit report stating that GAAS has been followed is merely a statement of opinion; other courts have indicated they would be open to possibly consider it to be a statement of fact, and two states have held it is a statement of fact. This issue is important because an auditor will face greater potential legal liability if a court considers the auditor's averment to be a statement of fact; if that is the situation, then a plaintiff could win a case against an auditor by merely showing that the auditor failed to perform the audit by GAAS.[50]

Statement of Opinion

In some states including Alabama,[51] California,[52] New York[53] and Texas[54] an auditor's stated compliance with GAAS is considered to be an opinion. The rationale for the classification of such statements as opinions appears to stem from the nature of the GAAS themselves, which Judge Kaplan characterized as "broadly stated" and "couched in rather general and in some cases inherently subjective terms."[55]

Statement of Fact

Two states Massachusetts[56] and Washington[57] have decided an auditor's averment is a statement of fact. Their justification is that the auditor's degree of compliance with GAAS is a verifiable factual statement that is material to those relying on its certification of the firm's internal controls.[58] Furthermore, because the auditor itself is the one tasked with complying with GAAS, the statement that an auditor has so complied in conducting its audit is best understood as one of fact. "There is no reason that an auditor cannot state with certainty that it followed the PCAOB standards and the GAAS therein as it understood them, including that it exercised the independent judgment that is required by those standards."[59]

Open to Possibility it is a Statement of Fact

Some states are undecided but have indicated they may be open to considering an auditor's averment of GAAS compliance to be a statement of fact; they include Florida[60] and Utah.[61]

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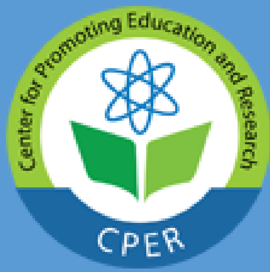
[37] AS 2401.08.
[38] AS 2401.09.
[39] AS 2401.11.
[40] AS 2401.13.
[41] AS 2401.52.
[42] In Ramanan v. Cal. Bd. Of Accountancy, 2019 Cal. App. Unpub. LEXIS 5696 (Cal. App., 6th Dist. 2019), the CPA lost his license after committing numerous GAAS violations, including failing to make inquiries of management relating to fraud. Id. at 67.
[43] AS 2401.53.
[44] AS 2401.56.
[45] AS 2401.57 through AS 2401.62.
[46] AS 2401.63 through AS 2401.65.
[47] AS 2401.66, AS 2401.67 and AS 2401.67A.
[48] AS 2401.79 through AS 2401.82.
[49] AS 2401.83.
[50] Miller Inv. Trust v. Morgan Stanley & Co., LLC, 308 F. Supp. 3d 411, 431 (D. Mass. 2018).
[51] In re Colonial Bancgroup, Inc. Sec. Litig., 9 F. Supp. 3d 1258, 1264-65 (M.D. Ala. 2014).
[52] Buttonwood Tree Value Partners, LP v. Sweeney, No. SACV 10-00537-CJC, 2012 U.S. Dist. LEXIS 80118, 2012 WL 2086607, at 2 (C.D. Cal. June 7, 2012).
[53] In re Lehman Bros. Sec. & ERISA Litig., 799 F. Supp. 2d 258, 302 (S.D.N.Y. 2011).
[54] Johnson v. CBD Energy, Ltd., 2016 U.S. Dist. LEXIS 87174 (S.D. Tx., Houston 2016).
[55] Id. at 300.
[56] Miller Inv. Trust v. Morgan Stanley & Co., LLC, Note 50.
[57] In re Wash. Mut., Inc. Sec., Deriv. & ERISA Litig., 694 F. Supp. 2d 1192 (W.D. Wash. 2009).
[58] Id. at 1224.
[59] Miller Inv. Trust v. Morgan Stanley & Co., LLC, Note 50 at 430. The client firm gave auditor KPMG false information during the audit which led to an erroneous unqualified audit opinion. Because of the false information was given, KPMG was held not to be liable and its Motion to Dismiss the lawsuit against it was granted. Id.
[60] Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc., 595 F. Supp. 2d 1253, 1282 (M.D. Fla. 2009).
[61] Deephaven Private Placement Trading, Ltd. v. Grant Thornton & Co., 454 F.3d 1168, 1175-76 (10th Cir. 2006).



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The Legal Effect of "Red Flags" Indicative of Fraud

Some courts have ruled that an auditor's failure to recognize evidence of potential fraud ("red flags") uncovered during the audit, or failure to respond to them if they are discovered, may be sufficient to establish auditor liability. For example, in the *Anwar* case, the auditor's failure to respond to red flags was sufficient to allege scienter in securities fraud, gross negligence, and aiding and abetting breach of fiduciary duty.[62]

Other courts have ruled that failure to recognize or to respond to red flags is insufficient to establish an auditor liability. For example, in a case alleging securities fraud and violations of the Exchange Act by auditor Deloitte,[63] the plaintiff client firm alleged that the audit was a "total failure" because of the auditors:

- Failure to verify that many of its bank deposits had been pledged as collateral to secure the obligations of third parties;
- Failure to disclose that the CEO had a 50% ownership interest in a Hong Kong firm ostensibly owned by the client firm;
- Failure to discover that the CEO looted $35 Million from one of the client firm's bank accounts;
- Failure to discover that the client firm never received a payment of $5 Million for sale of stock to a related party;
- Failure to discover what happened to the millions of dollars reportedly paid to purchase three universities, purchases which were never consummated; and
- Failure to explain why millions of dollars were paid to parties that had no legitimate business relationship with the client firm.[64]

However, the court ruled that the failure to investigate the red flags was not enough to prove auditor liability if the auditor was not aware of facts indicating a transaction was suspicious, or part of a fraud.[65] "An unseen red flag cannot be heeded."[66] "An auditor is a watchdog, not a bloodhound. As a matter of commercial reality, audits are performed in a client-controlled environment."[67] Furthermore, the plaintiff was unable to meet the very stringent pleading requirements for auditor scienter in a securities fraud case. To show recklessness on the part of a non-fiduciary auditor, such recklessness must be conduct that is highly unreasonable representing an extreme departure from the standards of ordinary care. It must approximate an actual intent to aid in the fraud being perpetrated by the client firm.[68] Allegations of a negligent or "shoddy audit," including failure of the auditor to notice or to respond to red flags, are insufficient to establish fraudulent intent.[69] Accordingly, Deloitte's Motion For Summary Judgment was granted, although without prejudice.[70]

The *in Pari Delicto* Defense

The doctrine of *in pari delicto* mandates that the courts will not intercede to resolve a dispute between two wrongdoers.[71] The purpose of the *in pari delicto* doctrine is to deter illegality by denying relief to parties who have admittedly broken the law while avoiding forcing courts to intercede in disputes between two wrongdoers. "No court should be required to serve as paymaster of the wages of crime, or referee between thieves."[72]

When presented as an affirmative defense to a tort claim, *in pari delicto* "bars a party that has been injured as a result of its intentional wrongdoing from recovering from another party whose equal or lesser fault contributed to the loss."[73] The defense requires intentional conduct on the part of the plaintiff or its agents.[74]

Courts have sometimes applied the *in pari delicto* doctrine to bar claims against auditors in situations where the auditors failed to detect or expose fraud committed by top corporate managers. For example, the New York Court of Appeals, the state's highest court, received a certified question from the Supreme Court of Delaware in 2010:

> "Would the doctrine of *in pari delicto* bar a derivative claim under New York law where a corporation uses its outside auditor for professional malpractice or negligence *based on the auditor's failure to detect fraud* committed by the corporation; and, the outside auditor did not knowingly participate in the corporation's fraud, but instead, failed to satisfy professional standards in its audits of the corporation's financial statements?"[75] (Emphasis added.)

The New York Court of Appeals ruled that *in pari delicto* does bar such a claim. The court ruled that the policy principle underlying *in pari delicto* "preventing the creditors and shareholders of the company that employs miscreant agents to enjoy the benefit of their misconduct without suffering the harm" supported the doctrine's application to bar a corporation's negligence claim against an auditor.[76]

Since the *Kirschner* case was decided, courts applying New York law of *in pari delicto* to claims against a corporate auditor have recognized the doctrine exclusively where corporate management was alleged to have engaged in intentional wrongdoing or fraud.[77] Conversely, courts have declined to apply *in pari delicto* where a corporate agent did

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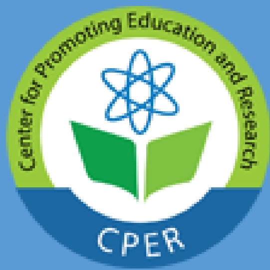
[62] Anwar v. Fairfield Greenwich Ltd., 728 F. Supp. 2d 372 at 411, 437 (S.D.N.Y. 2010).
[63] Special Situations Fund III QP, L.P. v. Deloitte Touche Tohmatsu CPA, Ltd., 33 F. Supp. 3d 401 (S.D.N.Y. 2014).
[64] Id. at 421-22.
[65] Iowa Pub. Employee's Ret. Sys. v. Deloitte & Touche LLP, 919 F. Supp. 2d 321, 332 (S.D.N.Y. 2013).
[66] Stephenson v. Citgo Grp. Ltd.,700 F. Supp. 2d 599, 623 (S.D.N.Y. 2010).
[67] Special Situations Fund III QP, Note 63 at 427.
[68] Rothman v. Gregor, 220 F. 3d 81, 98 (2d Cir. 2000).
[69] In re MRU Holdings Sec. Litig., 769 F. Supp. 2d 500, 518 (S.D.N.Y. 2011).
[70] Special Situations Fund III QP, Note 63 at 412.
[71] Kirschner v. KPMG, 15 N.Y.3d 446, 463-465 (N.Y. 2010).
[72] Id. However, in pari delicto is not applicable to an auditor's failure to detect fraud if the doctrine has been superseded by a statute. Chelsea Housing Authority v. McLaughlin, 125 N.E.3d 711 (Mass. 2019).
[73] In re Lehr Constr. Corp., 551 B.R. 732 (S.D.N.Y. 2016).
[74] Kirschner v. KPMG, Note 71 at 464.
[75] Teachers' Ret. Sys. of La. v. PricewaterhouseCoopers LLP, 998 A.2d 280, 282-283 (Del. 2010).
[76] Deangelis v. Corzine (in re MF Global Holdings Inv. Litig.), 998 F.Supp.2d 157, 189-190 (S.D.N.Y. 2014).
[77] CRC Litig. Trust v. Marcum LLP, 132 A.D.3d 938 (N.Y. App. Div. 2d Dept. 2015).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not intentionally provide inaccurate financial statements to its outside auditor but did so negligently.[78] If there is no evidence of intentional wrongdoing by the company's management, then *in pari delicto* will not bar a suit against the auditor.[79] But even if there are wrongful acts of corporate managers, *in pari delicto* will be inapplicable if the corporate directors are innocent.[80]

The Adverse Interest Exception

Some states have come to recognize exceptions to *in pari delicto*. The most common one is the Adverse Interest Exception. To fall within this exception, a corporate agent must have abandoned his principal's interest and be acting entirely for his own or another's purposes. It cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal. The rule avoids ambiguity where there is a benefit to both the insider and the corporation, and reserves this most narrow of exceptions for those blatant cases of outright theft or looting, or embezzlement.[81] The rationale for this exception illustrates its narrow scope. The presumption that an agent will communicate all material information to the principal operates except in the narrow circumstance where the corporation is the victim of a scheme undertaken by the agent to only benefit himself or a third party personally, which is therefore entirely opposed ("adverse") to the corporation's interests; in this situation, the Adverse Interest Exception will make *in pari delicto* inapplicable. However, if the agent engages in wrongdoing to benefit *both* himself and the company, then the Adverse Interest Exception will not apply.[82]

The Fiduciary Exception

The most expansive exception is the Fiduciary Exception: *in pari delicto* does not apply in a suit by a corporation against its fiduciaries. The underlying justification is that parties like receivers, trustees, and stockholder derivative plaintiffs must be able to act on the corporation's behalf to hold faithless directors and managers accountable. To hold otherwise would be to let fiduciaries immunize themselves through their own wrongful, disloyal acts. The Fiduciary Exception ensures that stockholders have a remedy for the wrongdoing that caused them harm.[83]

The Auditor Exception

At least two states New Jersey and Pennsylvania recognize the Auditor Exception to *in pari delicto*. This is based on the proposition that immunization of auditors from malpractice claims would not be good public policy.[84]

The Supreme Court of New Jersey held that a liquidation trustee was not barred from bringing a negligence claim against an auditor whose alleged negligence contributed to the damages caused by the fraud of the liquidated corporation's insiders. This ruling is intended to allow only innocent shareholders to recover damages, so the assessment of the relative fault of the wrongdoers is a factual question for the jury to decide at trial.[85]

The Supreme Court of Pennsylvania responded to a fact pattern involving alleged auditor participation in corporate insiders' fraud by qualifying its common law of *in pari delicto* slightly differently. The court used a good-faith test to determine whether the insiders' fraud should be imputed to the corporation and whether claims against auditors should be barred. Specifically, the court precluded reliance on *in pari delicto* by an auditor who has not dealt with the client corporation in good faith.[86]

Delaware considered whether to adopt the Auditor Exception in its entirety but instead decided to recognize a partial Auditor Exception. Delaware considers whether the Auditor Exception applies to each of the claims alleged against an auditor. In the deciding case, the court recognized that the Auditor Exception was applicable to bar breach of contract and negligence claims against an auditor, but the court allowed a claim that the auditor had aided and abetted the breach of fiduciary duties to be tried.[87]

Representative Cases of Auditor Liability

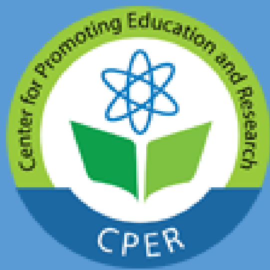
BDO Fails to Detect Massive Fraud

The responsible officer of a reorganized Florida LLC (Bankest, LC) filed a lawsuit against auditor BDO, alleging BDO was professionally negligent and had aided and abetted Bankest's officers in committing fraud.[88]

BDO's audit of Bankest was a textbook example of what an auditor should not do:

- BDO did not maintain independence from Bankest because it had a financial interest in one of Bankest's clients. In the words of the plaintiff's expert witness, this was "a convoluted, intertwined, first-class conflict of interest. . . one of the worst conflicts I've ever seen."[89]Ignoring red flags indicating fraud: Bankest would not produce requested documents that would have revealed that the purported accounts receivable were fictitious. BDO did not insist on the production of the documents because it wanted to maintain a good relationship with the company and believed this would lead to new business for BDO.[90]

[78] Sacher v. Beacon Assocs. Mgmt. Corp., 114 A.D.3d 655 (App. Div. 2d Dept. 2014).
[79] MF Global Holdings, Ltd. v. PricewaterhouseCoopers LLP, 199 F.Supp.3d 818, 834 (S.D.N.Y. 2016).
[80] Freeman v. BDO Seidman, LLP (in re E.S. Banest, L.C.), 2010 Bankr. LEXIS 1288 (S.D. Fla., Miami Div. 2010).
[81] However, Colorado law does not limit the adverse interest exception to theft or looting or embezzlement. Rather, Colorado law extends the exception to instances of fraud-related misconduct. See, In re Stat-Tech Sec. Litig., 905 F.Supp. 1416, 1422 (D. Colo. 1995), concluding that a corporation's employees "acted adversely to the interest of the corporation" when they made misrepresentations in corporate filings. Id.
[82] Okimoto v. Youngjun Cai, 2015 U.S. Dist. LEXIS 68295 (S.D.N.Y. 2015).
[83] Stewart v. Wilmington Trust SP Servs., 112 A.3d 271, 304 (Del. Chan. 2015).
[84] Id. at 315-323.
[85] NCP Litigation Trust v. KPMG, LLP, 901 A.2d 871 (N.J. 2006).
[86] Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PriceWaterhouseCoopers, LLP, 989 A.2d 313 (Pa. 2010).
[87] Stewart v. Wilmington Trust SP Servs., Note 83 at 320.
[88] Freeman v. BDO Seidman, LLP (in re E.S. Bankest, L.C.), Note 80.
[89] See In re MicroStrategy, Inc. Sec. Litig., 115 F. Supp. 2d 620, 655 (E.D. Va. 2000), holding that auditor's partnership with client destroyed independence and created motive for auditor to ignore indicia of fraud that supported inference of scienter).
[90] See In re Suprema Specialties, Inc. Sec. Litig., Note 20 at 280, noting that client's refusal to provide requested documents is a red flag raising suspicion of fraud. Id.



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- BDO did not mail out accounts receivable confirmations, which would have revealed hundreds of millions of dollars of fake accounts receivable over seven years. Plaintiff's expert witness stated the failure to send out confirmations to customers would "cause the hair on the back of an auditor's neck to stand up." In its audit reports, BDO falsely certified hundreds of millions of dollars' worth of fictitious accounts receivable on the client's books.
- Allowing the managers to loot the company for hundreds of millions of dollars. The magnitude of the fraud BDO failed to detect over seven years is breathtaking and it raises an issue of fact as to scienter.[91]
- The corporate directors were innocent and did not participate in the managers' fraud. The directors could have taken action to stop the fraud, but BDO never informed them of the fraud and allowed the fraud to continue.
- In its contract with Bankest, BDO agreed it had a duty to detect fraud and BDO failed in this duty because it allowed the managers to loot millions of dollars from the company.[92]

After the discovery in the case, there appeared to be more than enough evidence to prove BDO was professionally negligent and was culpable in aiding and abetting fraud.

PricewaterhouseCoopers Liable for $625 Million

PricewaterhouseCoopers (PwC) audited the books of Colonial Bank group, Inc. (Colonial) from 2002 to 2009 and issued unqualified opinions during those years. During this period, Colonial's largest customer, Taylor, Bean & Whitaker Mortgage Corporation (TBW), conspired with several Colonial managers to conduct a massive fraud of Colonial's assets. After the fraud was exposed, Colonial was placed into receivership with the FDIC. The FDIC and Colonial filed separate lawsuits against PwC for professional negligence. The suit filed by Colonial against PwC was dismissed because of the doctrine of *in pari delicto* since PwC and Colonial were both wrongdoers. However, the suit filed by the FDIC against PwC went to trial, where the court held that PwC was liable for professional negligence; PwC was ordered to pay $625 Million in damages.[93]

Colonial had been one of the 25 largest banks in the United States with over $26 billion in assets and more than 340 branches mostly in the southern part of the country. The bank provided short-term funding to mortgage originators, including TBW. The fraud conspiracy's ringleaders were the CEO at TBW and the senior vice president at Colonial in charge of mortgage lending. TBW was allowed to overdraw on its account, and by the time the fraud was discovered in 2009, the fraud amounted to $1.4 Billion of mortgage trades, all of which were fake.[94]

PwC's numerous errors included:

- Failing to plan audits to include a search for fraud, resulting in the insufficient gathering of enough fraud-related evidence;
- Not inspecting the files of the bank's loans;
- Not following up when confronted with illogical dates on the client firm's financial reports;
- Failing to understand some departments of the client firm, and delegating that responsibility to a college intern;
- Not physically inspecting the collateral of the loans; and
- Failing to follow up when tested sample loans failed to meet audit expectations.[95]

Representative Cases of Non-Liability of Auditor

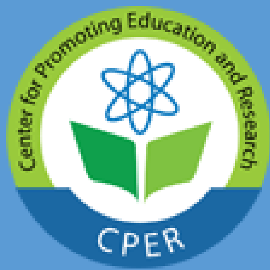
<u>Auditor UHY Not Liable Because It Did Not Knowingly or Recklessly Issue False Audit Report</u>

EXXI was founded in 2005 to engage in offshore oil exploration and extraction in the Gulf of UHY audited EXXI's financial statements for four years during 2011-2015. In each of those years, UHY issued an unqualified opinion. However, those unqualified opinions were materially false and misleading because: (1) the audits were not conducted under GAAS; and (2) EXXI's financial statements did not present fairly the company's true financial position and results of operations and did not comply with GAAP.[96]

About non-adherence with GAAS, UHY failed to respond to several red flags that should have raised suspicion of fraud: (1) unsupported balances and transactions; (2) inconsistent, vague, or implausible responses from management arising from inquiries or unusual results noted in analytical procedures; (3) lack of timely and appropriate documents; (4) missing documents; and (5) evasive or unreasonable responses of management to audit reports.[97]

About the financial statements' non-adherence to GAAP, the most critical item is that they failed to disclose the millions of dollars in loans to one of the company's owners from EXXI's vendors and from one of the company's directors who was also an affiliate of one of the company's largest shareholders.[98] Furthermore, in 2015, EXXI disclosed they were required to restate their financial statements for the past four years to eliminate cash flow hedge accounting; however, this was materially false and misleading because it made it appear that the reason for the restatement was a mere technical deficiency in the documentation, when the true reason for the

[91] See In re Sunbeam Secs. Litig., 89 F. Supp. 2d 1326, 1345 (S.D. Fla. 1999), where the sheer magnitude of the fraud raised an issue of fact as to auditor scienter.
[92] Freeman v. BDO Seidman, LLP (In re E.S. Bankest, L.C.), Note 80.
[93] Colonial Bancgroup, Inc. v. PricewaterhouseCoopers LLP, 2018 U.S. Dist. LEXIS 120877 (M.D. Ala., N. Div. 2018).
[94] Id. at 11.
[95] Id. at 13.
[96] Plaisance v. Schiller, 2019 U.S. Dist. 42073 (S.D. Tex., Houston 2019) at 30.
[97] Id.
[98] Id.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restatement was that the company was hedging for improper purposes, including speculating on future oil and gas prices or manipulating revenue and earnings.[99]

Because UHY's audit reports were materially false and misleading, plaintiff shareholders sued the auditor for violation of Section 10(b) of the Exchange Act and SEC Rule 10b-5.[100]

After discovery, auditor UHY filed a Motion to Dismiss. The court noted that the plaintiff's burden for proving the auditor's scienter in a securities fraud case is stringent: the plaintiff must prove that the auditor was reckless, not merely negligent. The court held that plaintiff failed to raise facts capable of establishing that when UHY issued its audit reports, UHY knew or was severely reckless in not knowing that its audit opinions contained statements that were false or misleading. The court disagreed with the plaintiff's allegation that UHY's audit was so deficient that it amounted to "no audit at all." The court held that plaintiff's allegations were not capable of raising a strong inference of UHY's scienter; UHY's failure to discover the accounting deficiencies might arguably support an allegation of negligence, but not a fraud.[101] Accordingly, auditor UHY's Motion to Dismiss the case was granted.[102]

Plaintiff's Motion for Summary Judgment Denied Due to Fact Issues as to Whether Auditor Knew that Client Was Committing Fraud

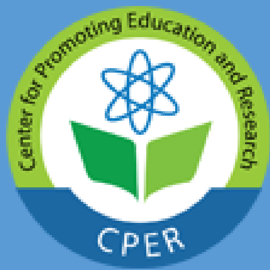
Quintanilla audited EGMI's financial statements during 2006-2009 and issued an unqualified opinion in each of those years. During that period, EGMI's CEO and CFO had created and filed false financial statements. EGMI went bankrupt after the financial statements were filed. The SEC filed a lawsuit on behalf of the EGMI shareholders, alleging the auditor committed violations of federal securities law: Exchange Act Section 10A, Section 10(b) and Rule 10b-5; and Securities Act Section 17(a). Plaintiff SEC alleged the auditor knew the financial statements were false when he issued the unqualified opinions, but the auditor denied he had such knowledge.[103]

After discovery, the plaintiff filed a Motion For Summary Judgment on all claims against The court denied the motion, holding that summary judgment was precluded because of disputed issues of material fact, *to wit*: whether the defendant's audit had included procedures designed to provide reasonable assurance of detecting illegal acts; and whether, in the course of conducting the audit, the auditor detected or otherwise became aware of information indicating that an illegal act had or may have occurred.[104]

Conclusions

1. Auditors are occasionally sued for their failure to detect fraud in the client firm during an audit. These lawsuits are typically grounded in professional negligence, negligent misrepresentation, fraud, aiding and abetting fraud, or federal securities fraud.
2. The Public Company Accounting Oversight Board recently promulgated AS 2401, "Consideration of Fraud in a Financial Statement Audit." AS 2401 contains fraud-related Generally Accepted Auditing Standards (GAAS) applicable to audits of publicly-traded entities. If an auditor does not comply with GAAS during an audit, then a plaintiff may be able to use those infractions to prove the auditor was professionally negligent.
3. Some states consider an auditor's averment of compliance with GAAS in an audit report to be a statement of opinion, but other states consider it to be a statement of fact. In the latter states, it will be easier to prove a legal case against an auditor.
4. An auditor's failure to recognize or to investigate "red flags" indicating potential fraud is one factor used to determine whether an auditor is legally liable, but this will not necessarily be dispositive if the auditor was unaware of the red flags.
5. An auditor-defendant may be able to use the doctrine of *in pari delicto* as a defense if the plaintiff is also a wrongdoer. However, three states New Jersey, Pennsylvania, and Delaware have an Auditor Exception to this doctrine. In those states, an auditor may be legally liable even if the plaintiff is also a wrongdoer

[99] Id.
[100] Id.
[101] Id.
[102] Id.
[103] SEC v. Cole, 2015 U.S. Dist. LEXIS 132637 (S.D.N.Y. 2015).
[104] Id. See SEC v. Solucorp Indus., Ltd., 197 F. Supp. 2d 4, 11 (S.D.N.Y. 2002), where a defendant-auditor's summary judgment motion was denied after finding that there is a genuine issue of material fact as to whether the auditor was aware of information indicating that an illegal act may have occurred. Id.



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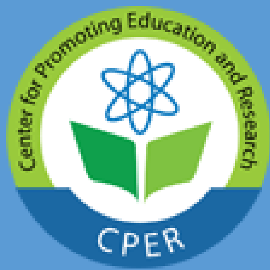
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Public Company Accounting Oversight Board, "AS 2201: "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements," paragraphs .14-.15; https://pcaobus.org/oversight/standards/auditing-standards/details/AS2201 .
Public Company Accounting Oversight Board, "AS 2401: Consideration of Fraud in a Financial Statement Audit;" https://pcaobus.org/oversight/standards/auditing-standards/details/AS2401 .