Ninth Circuit Court of Appeals Increases Vulnerability of Auditors in Suits Alleging Fraudulent Backdating of Stock Options

New Mexico State Investment Council v. Ernst & Young LLP

Last week, the Ninth Circuit Court of Appeals held that outside auditors are subject to a federal securities lawsuit by a corporation's shareholders, and are not benefitted by any heightened "scienter," or state of mind, requirement. The Ninth Circuit accordingly recently reversed a district court's dismissal of a class action complaint against Ernst & Young LLP for its alleged participation in a multi-billion dollar fraudulent stock options backdating scheme by client Broadcom Corporation. The result of this decision is likely to be increased threat of exposure of outside auditors to suits by third parties, such as the shareholders of clients.

Broadcom, a semiconductor company with revenues exceeding $2.5 billion in 2006, was alleged to have engaged in an improper stock options backdating scheme for nearly a decade, requiring Broadcom to restate its financial statements for those years. As explained by the Ninth Circuit, "[b]ackdating 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." Accounting principles require that when a company backdates stock options, it must record an expense for the "profit," which is essentially treated as compensation to the option recipient. Failure to properly record the backdated options would inflate the company's net income, potentially deceiving the market and investors.

Plaintiffs claimed that Ernst & Young, as Broadcom's auditor, was complicit in the stock option backdating scheme, and complicit in fraudulent accounting practices that caused Broadcom's stock to be artificially inflated. The district court granted the auditor's motion to dismiss, stating that the allegations of Ernst & Young's scienter were insufficient and that "there's a little bit of a heavier burden of allegations on accountants on the question of scienter."

The Ninth Circuit rejected the district court's view that scienter allegations against accountants or auditors carry "a little bit of a heavier burden." Rather, the court stated, a securities fraud complaint adequately pleads scienter by "raising a strong inference that the defendant possessed actual knowledge or acted with deliberate recklessness." Here, the court noted several specific points in time when the auditor was aware of circumstances that would have compelled a reasonable auditor to further investigate and to disclose the improper backdating of options. Taken individually, and as a whole, the court found that these alleged "red flags" were sufficient to support a strong inference of scienter and to withstand the auditor's motion to dismiss. Thus, even though Ernst & Young had issued an unqualified audit opinion in 2005 confirming that Broadcom's financial statements were valid and prepared in conformity with generally accepted accounting principles, the appellate court found that the complaint contained sufficient allegations of the "strong inference" necessary to the pleading of scienter.

The decision illustrates some of the differences between federal and state law with respect to auditor liability. Plaintiffs in this case brought their claims under Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) and Securities Exchange Commission Rule 10b-5. Under federal securities law, accountants may be held liable to actual purchasers or sellers of securities for fraud or gross negligence. Under present California law, auditors cannot be held liable on a general negligence theory where there is no privity of contract with the plaintiff, even if the plaintiff is an intended beneficiary of an audit report. *See e.g., Bily v. Arthur Young & Co.* (1992) 3 Cal.4th 370, 413-16.

We anticipate that *New Mexico State Investment* may be cited as support for such a claim in the state court forum. The decision is citable precedent now. The result in this case may change if a petition for rehearing at

the Ninth Circuit, or certiorari from the Supreme Court, is granted.

Contributed by:

Gordon & Rees, LLP
101 W. Broadway
Suite 2000
San Diego, CA 92101

Matthew Riley, Esq.
(619) 696-6700
mriley@gordonrees.com

Don Willenburg, Esq.
(619) 696-6700
dwillenburg@gordonrees.com

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For questions or further information, please contact Bruce Margolin at (212) 458-9316, bruce.margolin@chartisinsurance.com; or Steve Lessick at (212) 458-9315, steven.lessick@chartisinsurance.com.