

Client Alert

Second Circuit Holds That Mere Auditor “Review” Of Quarterly Financials Will Not Give Rise To Liability Under The Federal Securities Laws

Auditors for years have distinguished between the familiar traditional “audit,” which is usually performed annually, and a quarterly “review.” A “review” typically consists more of just discussion and observations rather than the performance of substantive audit procedures, and principally involves applying analytical procedures to the company’s financial data, making inquiries of the company’s officers responsible for financial and accounting matters, and bringing to management’s attention if anything is observed that is in contravention of GAAP (generally accepted accounting principles). In a recent ruling, the United States Court of Appeals for the Second Circuit held that an auditor cannot be held liable under the federal securities laws for alleged misstatements contained in a company’s quarterly financial statements that the auditor had reviewed but not audited.

In *Lattanzio et al. v. Deloitte & Touche LLP*, No. 05-5805, 2007 WL 259877 (2d Cir. Jan. 31, 2007), plaintiffs brought a putative class action against a company’s auditor, alleging that there had been numerous misstatements in the company’s yearly and quarterly financial statements, and asserting claims for breach of fiduciary duty and violations of § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. The plaintiffs claimed to have suffered losses when the company later went into bankruptcy. The district court dismissed plaintiffs’ claims and plaintiffs appealed.

The Second Circuit affirmed on several grounds. First, the court held that the auditor could not be held liable for the alleged misstatements in the company’s unaudited quarterly financial statements that the auditor had simply reviewed. The court noted that, under *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), a defendant can only be liable under the federal securities laws for its own material misstatements, not for aiding and abetting another’s violation. The court further noted that while the quarterly financial statements at issue had been reviewed by the auditor, they “did not contain an audit opinion by [the auditor], and were not attributed to [the auditor] when they were disseminated.” The court held that the auditor “is not liable for merely assisting in the drafting and filing of the quarterly statements.”

The court rejected the plaintiffs’ argument that since the company was required to have its quarterly statements reviewed by an auditor pursuant to 17 C.F.R. § 210.1001(d), the auditor’s “mandated review of [the company’s] quarterly financial statements associated [the auditor] with those statements to such a degree that they became [the auditor’s] statements....” The court held that this argument conflicted with the court’s prior opinion in *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), where the court held that a defendant could only incur § 10(b) liability if a misstatement is attributed to that defendant at the time the statement is disseminated. The mere “public understanding” created by § 210.1001(d) that the auditor had reviewed the quarterly statements does not “create an exception to the requirement that an actionable misstatement be made by the accountant.”

The court also rejected the plaintiffs’ argument that § 210.1001(d) “imposes on accountants an actionable duty under § 10(b) to correct the unaudited financial statements,” the breach of which amounts to a “statement” for purposes of § 10(b). The court held that such an argument would

expand the scope of liability under § 10(b) “beyond the scope of conduct prohibited by the statutory text.” Moreover, the court pointed out that since § 210.1001(d) gives a company an option to either include a report from its auditor in its quarterly statements or not, to impose liability on the auditor where the company had chosen not to include a report would render that option meaningless. Further, pointing to the numerous regulations governing the duties and requirements associated with an auditor’s annual audit and the absence of such regulations with respect to quarterly reviews, the court noted that “[c]learly Congress knows how to impose duties on accountants and expose them to liability, when it wants to do so.”

The court also rejected the plaintiffs’ attempt to recast their defective claim as one for breach of fiduciary duty, invoking the well-settled rule that an outside auditor does not owe a fiduciary duty to a company’s shareholders. The court additionally held that even if there had been misstatements in the company’s yearly audited financial statements made during the class period that could give rise to liability on behalf of the auditor, the plaintiffs still had failed to plead “loss causation” with regard to those alleged misstatements because, whatever the alleged misstatements’ other failings, they had not concealed the company’s risk of bankruptcy, which was the theory behind the plaintiffs’ case.

Accordingly, in *Lattanzio et al.*, the Second Circuit made clear that an auditor may not be held liable under the federal securities laws for alleged misstatements made in a company’s unaudited quarterly financial statements, even if the auditor had participated in or performed a “review” of those unaudited statements. *Lattanzio et al.*’s holding is consistent with the Second Circuit’s other recent accountant’s liability decision, *Overton v. Todman & Co.*, No. 06-2496, 2007 WL 574623 (2d Cir. Feb. 26, 2007), which held that an accountant’s duty to correct is limited to, among other things, the accountant’s own statements in its own certified audit opinion. The *Lattanzio et al.* decision should give comfort not only to the accounting industry performing quarterly reviews, but also to their clients, who are thus spared the increased time and expense that would undoubtedly be required for auditors’ review services if auditors had to face liability under the federal securities laws for errors in companies’ unaudited quarterly financial statements that the auditors merely reviewed.

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