

## Client Alert

# Second Circuit Confirms That Auditors Can Have A “Duty To Correct” Their Own Prior Misstatements Under The Federal Securities Laws

In a significant new ruling on the scope of auditor liability under the federal securities laws, the United States Court of Appeals for the Second Circuit has resolved a long-unsettled issue by confirming that an auditor may incur primary liability under § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 if the auditor fails to correct or withdraw statements in a certified opinion that the auditor later learns were false or misleading at the time made, if the auditor knows or has reason to know that potential investors may be relying upon those statements.

In *Overton v. Todman & Co.*, No. 06-2496, 2007 WL 574623 (2d Cir. Feb. 26, 2007), the auditor defendant audited the financial statements of a broker-dealer from 1999 through 2002, and, in each year, issued an “unqualified” opinion that the broker-dealer’s financial statements accurately portrayed its financial position. The auditor, however, made “significant errors” each year by inaccurately reporting the broker-dealer’s payroll tax liability. The errors were revealed in 2003 when the New York State Department of Taxation determined that the company had failed to pay its payroll taxes in 1999 or 2000.

Following that determination, the broker-dealer conducted an internal investigation and hired a forensic accounting firm which concluded that the auditor’s “audits were deficient and lacking in many respects.” The auditor was aware of the findings of both the Department of Taxation and the forensic accounting firm, yet it never took any steps to withdraw or correct its unqualified opinion. The broker-dealer then sought to raise additional capital to deal with its payroll tax liability, and as part of this process provided potential investors with its 2002 certified financial statements. According to the complaint, the auditor knew that the 2002 certified financial statements were being used to solicit potential investors.

The broker-dealer later collapsed. Plaintiff, an investor that had relied on the 2002 financial statements, brought suit in the Southern District of New York, alleging that the auditor violated § 10(b) and Rule 10b-5 by failing to correct its 2002 audit opinion after it became aware of the payroll tax liability error. The District Court reasoned that the auditor’s failure to correct its audit opinion would amount, if anything, only to aiding and abetting the broker-dealer’s primary violation of the securities laws, and that under *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), a defendant could not be held liable for merely aiding and abetting such primary violations. The District Court thus concluded that the auditor could not be held liable for failing to correct its audit opinion and dismissed the § 10(b) and Rule 10b-5 claims.

The Second Circuit reversed, holding that the auditor’s failure to correct its audit opinion could result in liability for a primary violation of § 10(b) and Rule 10b-5. The Second Circuit noted that it had previously “alluded” to a duty by an auditor to correct a certified audit opinion, but never squarely held that such a duty exists or that its violation would give rise to a primary violation of § 10(b) and Rule 10b-5. For example, in the pre-*Central Bank* case of *IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980), the court had held that an auditor could be found liable for aiding and abetting a violation of § 10(b) and Rule 10b-5 for failing to correct its certified statements, but *Central Bank* abrogated *Cornfeld*’s holding on that point and thus left unclear if there remained any basis to

impose federal securities law liability on the auditor in those circumstances. The Second Circuit in *Overton* further noted that in other decisions since *Cornfeld* it had essentially assumed, without ever formally deciding, that an auditor could be held liable for a primary violation of § 10(b) and Rule 10b-5 based upon the violation of the supposed “duty to correct.”

*Overton* gave the court the opportunity to cement its prior views on this auditor liability issue. The court “recognized that when an accountant issues a certified opinion, it creates . . . [a] special relationship with the investing public” which gives rise to a duty to disclose. Accordingly, it held that an auditor has a “duty to correct” an audit opinion, and thus may be held liable under § 10(b) and Rule 10b-5 for failing to do so, when it: “(1) makes a statement in its certified opinion that is false or misleading *when made*; (2) subsequently learns or was reckless in not learning that the earlier statement was false or misleading; (3) knows or should know that potential investors are relying on the opinion and financial statements; yet (4) fails to take reasonable steps to correct or withdraw its opinion and/or financial statements; and (5) all the other requirements for liability are satisfied.”

The court took pains to clarify the limits of its holding. Specifically, the court held that “the duty to correct requires only that the accountant correct statements that were false when made,” but did not require an auditor to update a statement which, although true when made, had become false or misleading in light of intervening events. The court specifically declined to reach the issue of whether an auditor has a “duty to update.” Furthermore, the court held that the duty to correct applies only to the statements in its audit opinion and/or the certified financial statements themselves, and does not require an auditor to “divulge information collateral to the statements of accuracy and financial fact set forth in its opinion and the certified financial statements, respectively.”

Thus, in *Overton*, Second Circuit confirmed what it had previously hinted at — that an auditor has a “duty to correct” or withdraw statements in a certified opinion that the auditor subsequently learned were false or misleading when made, and the failure to do so may give rise to liability under the federal securities laws in appropriate circumstances. While the circumstances in *Overton* were rather extreme — a company not just attempting to raise capital through use of past financial statements that were previously determined to be erroneous, but seeking that capital for the very purpose of helping remedy the tax consequences of those very past errors — the case is likely to provide the plaintiffs’ bar with some additional legal ammunition to aim at the accounting industry whenever there is trading in the stock of a company whose past financials were later found to be erroneous. Auditors who fail to correct or withdraw their prior certifications of financials that were later found to have been incorrect when made may now have to confront claims primary liability from injured investors under the federal securities laws.

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March 6, 2007

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