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**AUDITOR LIABILITY****Audit Opinions as Opinions: The Recent Trend Towards Applying a Subjective Falsity Standard For Auditor Liability**

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**I. Introduction**

**A**n auditor's report on a company's financial statements is not a certification, guarantee, or even a statement of fact. An auditor's report constitutes the auditor's *opinion* about the compliance of a company's financial statements with Generally Accepted Accounting Principles ("GAAP") based on the auditor's work performed under Generally Accepted Auditing Standards ("GAAS").

It has been more than 20 years since the United States Supreme Court issued its decision in *Virginia Bankshares, Inc. v. Sandberg*,<sup>1</sup> holding that for a plaintiff to plead falsity of a statement of opinion, it must plead that the statement was both objectively and subjectively false—in other words, that it was both untrue and not believed to be true by the speaker. Early district court decisions found this requirement inapplicable to claims that an auditor's report was false. Increasingly recognizing the "opinion" nature of an auditor's report on a company's financial statements, district courts are now requiring plaintiffs bringing securities claims against auditors to plead subjective falsity as to the auditor's report. This article analyzes this developing trend and whether *Virginia Bankshares'* subjective fal-

<sup>1</sup> 501 U.S. 1083 (1991).

sity standard requires plaintiffs to allege that an auditor did not genuinely believe its audit opinion.

## II. A Statement of Opinion Is Not Actionable Under the Federal Securities Laws Unless It Is Both Objectively and Subjectively False

In *Virginia Bankshares*, the United States Supreme Court considered allegations that an opinion was subjectively false but objectively true. In analyzing the opinion at issue, the Supreme Court explained that a statement of opinion has both subjective and objective components: “as statements that the [maker] . . . hold[s] the belief stated and as statements about the subject matter of the reason or belief expressed.”<sup>2</sup> The Supreme Court concluded that the statement of opinion was not actionable under the federal securities laws because it was not both objectively and subjectively false.<sup>3</sup>

Lower courts have since interpreted *Virginia Bankshares* to require both objective and subjective falsity for any statement of opinion to be actionable.<sup>4</sup> Thus, to plead the falsity of an opinion under *Virginia Bankshares*, a plaintiff must plead facts establishing both (1) that the speaker did not hold the opinion stated (subjective falsity), and (2) that the statements about the subject matter are false (objective falsity). Further, where claims based on opinions “sound in fraud,” such facts must be pleaded with particularity under Federal Rule of Civil Procedure 9(b).<sup>5</sup>

## III. Auditors’ GAAP and GAAS Statements Are Statements of Opinion

Although a company’s financial statements may contain many statements of fact, those statements are not made by the company’s independent auditors. “A company’s management—not the auditor—is responsible for the information contained in its financial statements and the propriety of its underlying accounting policies, including compliance with GAAP.”<sup>6</sup>

The independent auditor does not prepare, but audits the financial statements prepared by the company. An audit is an examination performed in accordance with the standards of the Public Company Accounting Oversight Board (United States), which are referred to as GAAS. At the conclusion of an audit, the auditor provides an audit report, which “is a professional opinion based on numerous and complex factors . . . [T]he report is based on the auditor’s interpretation and appli-

cation of hundreds of professional standards, many of which are broadly phrased and readily subject to different constructions. Although ultimately expressed in shorthand form, the report is the final product of a complex process involving discretion and judgment on the part of the auditor at every stage.”<sup>7</sup>

The standard audit report contains an introductory paragraph, a scope paragraph and an opinion paragraph. The introductory paragraph generally explains what has been audited: “We have audited the accompanying consolidated balance sheets of Company and subsidiaries as of December 31, 20XX . . .” The scope paragraph explains how the audits were conducted: “We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal controls over financial reporting was maintained in all material respects.” The scope paragraph also generally explains that the audit of the financial statements includes “examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.” Lastly, the opinion paragraph states the auditor’s opinion on the financial statements’ compliance with GAAP based on its audit: “In our opinion the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 20XX . . . in conformity with U.S. generally accepted accounting principles.”

Analyzing the three standard paragraphs in an audit opinion, the United States Court of Appeals for the Tenth Circuit in *Deephaven Private Placement Trading Ltd. v. Grant Thornton & Co.*<sup>8</sup> debunked the common misapprehension that auditors guarantee the accuracy of the financial statements. The court observed: “[A]uditors do not ‘certify’ a company’s financial statements in the sense that they ‘guarantee’ or ‘insure’ them. Nor do they, by virtue of auditing a company’s financial statements, somehow make, own or adopt the assertions contained therein.”<sup>9</sup> The court explained that “the end product of an audit is the audit report, which usually contains three concomitant paragraphs: the introduction, the scope and the opinion.”<sup>10</sup>

The *Deephaven* court then analyzed the three parts of a standard audit report: “Investors conveniently attempt to read [the auditor’s] opinion that the 1999 financial statements present [the company’s] financial position fairly in conformity with GAAP as an isolated statement of material fact. That is, [the plaintiffs] attempt to characterize it as a categorical statement separate from its stated basis.”<sup>11</sup> The court then explained: “The audit report does not, however, allow for such a cropped reading. To the contrary, the audit report must be read in its entirety. When so read, it is readily apparent that the introductory paragraph tethers [the auditor’s] opinion to its stated basis: [The auditor’s] factual assertion that its audits were performed in accordance

<sup>2</sup> 501 U.S. at 1092.

<sup>3</sup> *Id.* at 1096.

<sup>4</sup> See *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 110 (2d Cir. 2011) (citing *Virginia Bankshares* and holding that “when a plaintiff asserts a claim under section 11 or 12 based upon a belief or opinion alleged to have been communicated by a defendant, liability lies only to the extent that the statement was both objectively false and disbelieved by the defendant at the time it was expressed”).

<sup>5</sup> See *Rubke v. Capitol Bancorp Ltd.*, 551 F.3d 1156, 1162 (9th Cir. 2009) (“[M]isleading opinions . . . can give rise to a claim . . . only if the complaint alleges with particularity that the statements were both objectively and subjectively false or misleading.”).

<sup>6</sup> *Dronsejko v. Thornton*, 632 F.3d 658, 663 (10th Cir. 2011).

<sup>7</sup> *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 400 (1992).

<sup>8</sup> 454 F.3d 1168, 1171 (10th Cir. 2006).

<sup>9</sup> *Id.* at 1174 (internal citations omitted).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 1175-76.

with GAAS and therefore provide an adequate basis for its opinion.”<sup>12</sup>

The *Deephaven* court further explained: “The opinion paragraph, as the term suggests, is stated as an opinion of [the auditor] rather than a statement of absolute fact or a guarantee.”<sup>13</sup> “Because [an auditor’s] opinion is couched in terms of a stated basis, a claim that the former is false or misleading must necessarily specify the reason or reasons why in terms of the latter.”<sup>14</sup>

#### IV. Courts Have Articulated Differing Standards for Pleading the Falsity of Audit Opinions Post-Virginia Bankshares

The lower courts are increasingly applying the requirements of *Virginia Bankshares* to claims that audit reports are false. In so doing, however, the lower courts have adopted divergent approaches.<sup>15</sup>

##### A. Requirement That Plaintiffs Plead That the Auditor Did Not Believe Its Audit Opinions or Have Reasonable Basis for Them

Some courts have articulated a standard that allows for liability under *Virginia Bankshares* where plaintiffs allege facts establishing that the auditor either did not believe its opinion, or had no reasonable basis for it. For instance, in *Underland v. Alter*,<sup>16</sup> the court held that under Third Circuit precedent “statements of opinion” are actionable where there is no “reasonable basis” for the statement.<sup>17</sup> The Tenth Circuit similarly held in *Deephaven* that to plead falsity a plaintiff must “specify how (1) [an auditor] did not actually form its opinion regarding the . . . financial statements based on its audits; or (2) it did not have a reasonable basis for its opinion because it did not plan and perform its audits of the . . . financial statements in accordance with GAAS.”<sup>18</sup>

##### B. Requirement That Plaintiffs Plead That the Auditor Did Not Genuinely Believe Its Audit Opinion

Several other courts have articulated a standard that requires plaintiffs to allege that the auditor either did not believe or *knew* that it did not have a reasonable basis for its audit opinion. In *In re Lehman Bros. Sec. &*

*Erisa Litig.*,<sup>19</sup> the court held that the auditor’s “GAAS opinion, just like those rendered by all or substantially all accounting firms, is explicitly labeled as just that—an opinion that the audit complied with these broadly stated standards—more is necessary to make out a claim that the statement of opinion was false than a quarrel with whether these standards have been satisfied.”<sup>20</sup> The court recognized that “some courts have considered the sufficiency of securities claims against auditors based upon statements as to the compliance of financial statements with GAAP without regard to the significance of the fact that such statements have been couched as opinions and thus without regard to the importance of the fact-opinion distinction.”<sup>21</sup> The court, however, held that “the distinction is important.” The court explained the auditor’s GAAS statement was inherently one of opinion. Thus, to plead that such statement was false a plaintiff must “allege facts that, if true, would permit a conclusion that [the auditor] either did not in fact hold that opinion or knew that it had no reasonable basis for it.”<sup>22</sup> Similarly, with respect to the auditor’s GAAP opinion, the court held that the plaintiff must allege “facts sufficient to warrant a finding that the auditor did not actually hold the opinion it expressed or that it knew that it had no reasonable basis for holding it.”<sup>23</sup>

In *Buttonwood Tree Value Partners, LP v. Sweeney*,<sup>24</sup> the court similarly dismissed claims against an auditor where the plaintiffs failed to plead subjective falsity. The court explained: “Where a plaintiff challenges an opinion statement under the securities law, the plaintiff must allege with particularity that the defendant believed his or her opinion was false.”<sup>25</sup> The court concluded that “both the GAAS assertion and GAAP assertions are matters of opinion, because both GAAS and GAAP are a collection of broad standards that are ‘couched in rather general and in some cases inherently subjective terms . . . requir[ing] for example, that the auditor plan the audit engagement properly, use ‘due professional care,’ exercise ‘professional skepticism,’ and ‘assess the risk of material misstatement due to fraud all matters as to which reasonable professionals planning or conducting an audit reasonably and frequently could disagree.’”<sup>26</sup> The court then concluded that plaintiffs were required to plead that the auditor’s GAAP and GAAS statements were subjectively false, and that they failed to allege facts sufficient to satisfy this requirement.<sup>27</sup>

After the court dismissed the complaint in *Buttonwood*, the plaintiffs filed an amended complaint, which was also dismissed because the plaintiffs failed to plead subjective falsity. The court explained: “In its Order dismissing the [complaint], the Court held that Plaintiffs must plead subjective falsity because an auditor’s GAAS and GAAP assertions are statements of professional judgment and opinion, not verifiable fact. Plain-

<sup>12</sup> *Id.* at 1176.

<sup>13</sup> *Id.* at 1175.

<sup>14</sup> *Id.* at 1176.

<sup>15</sup> At least one court has recently held contrary to the prevailing trend that an audit report contained only statements of fact. See *In re Washington Mut., Inc. Sec., Derivative & ERISA Litig.*, 694 F. Supp. 2d 1192, 1224 (W.D. Wash. 2009). As discussed herein, more recent decisions disagree. See, e.g., *Buttonwood Tree Value Partners, LP v. Sweeney*, No. SACV 10-537 CJC, 2012 BL 343590 (C.D. Cal. June 7, 2012) (auditor’s GAAP and GAAS statements are statements of opinion); *Hufnagle v. Rino Int’l Corp.*, CV 10-08695 DDP VBKX, 2013 BL 11987, at \*3 (C.D. Cal. Jan. 14, 2013) (following *Buttonwood* and declining to follow *Washington Mut.*).

<sup>16</sup> CIV.A. 10-3621, 2012 BL 239122, at \*3 n.10 (E.D. Pa. Sept. 18, 2012),

<sup>17</sup> *Id.* (citing *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1428 (3d Cir. 1997)).

<sup>18</sup> 454 F.3d at 1176.

<sup>19</sup> 799 F. Supp. 2d 258 (S.D.N.Y. 2011),

<sup>20</sup> *Id.* at 300-01.

<sup>21</sup> *Id.* at 302.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 303.

<sup>24</sup> SACV 10-00537-CJC, 2012 BL 343590 (C.D. Cal. June 7, 2012),

<sup>25</sup> *Id.* at \*2 (citations omitted).

<sup>26</sup> *Id.* at \*3

<sup>27</sup> *Id.*

tiffs' arguments have not convinced the Court otherwise."<sup>28</sup> The court held that plaintiffs' allegations that the auditor knew it had no legal or professional justification for blessing the financial statements was insufficient because the complaint was "completely devoid of any substantive allegation demonstrating that [the auditor] did not genuinely believe its opinions to be accurate when they were issued."<sup>29</sup>

In *Belmont Holdings Corp. v. SunTrust Banks, Inc.*,<sup>30</sup> the auditor sought reconsideration of the order denying its motion to dismiss because, among other reasons, the auditor's statements were statements of opinion and plaintiffs did not allege that its audit opinions were subjectively false when issued.<sup>31</sup> The court agreed that the claims were based solely on the auditor's audit opinions, granted the motion for reconsideration, and reasoned: "A plaintiff in a securities fraud action who asserts claims against an accountant based on the accountant's audit opinions is required to allege, with particularity, that the opinions issued were subjectively false—that is that the accountants did not actually believe their opinions when they were issued."<sup>32</sup> Applying this standard, the court held that "[t]he scant allegations in Plaintiff's Amended Complaint fail to state a claim that the [auditor] audit opinions were subjectively false when issued and fail to satisfy the requirements of Federal Rule of Civil Procedure 9(b) by failing to specify the who, what, where, when, and how regarding the development and falsity of [the auditor's] audit opinions."<sup>33</sup> The court further explained that the allegations against the auditor were "conclusory, if not speculative" and that the complaint did not "sufficiently allege particularized facts regarding the subjective falsity of [the auditor's] audit opinions or facts to satisfy the requirements of Federal Rule of Civil Procedure 9(b)."<sup>34</sup>

In *re Longtop Fin. Technologies Ltd. Sec. Litig.*<sup>35</sup> is also consistent with this perspective. There, the court also considered the alleged falsity of an auditor's GAAS statements. The court followed *In re Lehman Bros. Securities and ERISA Litigation* and explained: "In the last case in this Circuit to examine this precise issue in detail, the court in *In re Lehman Bros. Securities and ERISA Litigation* held that auditor reports of GAAS compliance are 'inherently . . . one[s] of opinion.' Consequently, the *Lehman* court held, '[plaintiff must] allege facts that, if true, would permit a conclusion that [the auditor] either did not in fact hold that opinion or knew that it had no reasonable basis for it.'"<sup>36</sup> The *Longtop* court also adopted this "sensible approach" and held that to allege that an auditor's opinion is a misrepresentation, "a complaint must show that the statement in question is grounded on a specific factual premise that is false, and that the speaker did not 'genuinely or reasonably believe' it."<sup>37</sup>

<sup>28</sup> *Buttonwood Tree Value Partners, LP v. Sweeney*, SACV10-00537-CJC (C.D. Cal. Dec. 10, 2012).

<sup>29</sup> *Id.*

<sup>30</sup> 1:09-CV-1185-WSD (N.D. Ga. Aug. 28, 2012).

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> 11 CIV. 3658, 2012 BL 297896 (S.D.N.Y. Nov. 14, 2012).

<sup>36</sup> *Id.* at \*10.

<sup>37</sup> *Id.* at \*11.

In keeping with this trend, *Hufnagle v. Rino Int'l Corp.*,<sup>38</sup> recently applied the subjective falsity standard to the audit opinions at issue. The plaintiff there attempted to plead a Section 10(b) claim against the auditor based on the auditor's allegedly false opinion on the company's 2009 financial statements. The court recognized that the *Washington Mut.* court had declined to apply the subjective falsity requirement in response to "similar allegations" on the ground that the auditor had made statements of fact and not of opinion.<sup>39</sup> Agreeing with *Buttonwood* that the auditor's GAAS and GAAP assertions are statements of opinion and noting that plaintiff had alleged that the auditor issued false and misleading opinions, the *Hufnagle* court rejected the holding of the *Washington Mut.* court and required plaintiff to allege that the auditor's stated opinion was subjectively false.

## V. To Plead Falsity, Courts Should Require Plaintiffs to Allege That the Audit Opinion Was Not Genuinely Believed

Although courts have adopted different standards for pleading falsity of an audit opinion, the approach most consistent with *Virginia Bankshares* requires a plaintiff to plead that the auditor did not genuinely believe its audit opinion. Any other approach undermines the holding of *Virginia Bankshares*.

Courts should reject a reading of *Virginia Bankshares* that would permit plaintiffs to establish falsity merely by pleading that an auditor lacked a reasonable basis for its audit opinion. The Second Circuit recently did so in *Fait*. The *Fait* court explained: "Plaintiff relies mainly on allegations about adverse market conditions to support the contention that defendants should have reached different conclusions about the amount of and the need to test for goodwill. The complaint does not, however, plausibly allege that defendants did not believe the statements regarding goodwill at the time they made them."<sup>40</sup> Stated another way, despite the plaintiff's allegations that a different conclusion should have been reached based on the facts, the *Fait* court held that the plaintiffs were required to plead that the statements were not believed. Applying this reasoning to an audit opinion, allegations that an auditor "should have" reached a different conclusion is not enough. Plaintiffs must allege that the auditor did not believe its opinion.

This understanding of *Virginia Bankshares* comports with Justice Scalia's concurrence in that case: "As I understand the Court's opinion, the statement 'In the opinion of the Directors, this is a high value for the shares' would produce liability if in fact it was not a high value and the directors knew that. It would not produce liability if in fact it was not a high value but the directors honestly believed otherwise."<sup>41</sup> Under Justice Scalia's articulation of the *Virginia Bankshares* holding, an auditor could be liable only if the financial statements violated GAAP and the auditor knew that. The auditor

<sup>38</sup> CV 10-08695 DDP VBKX, 2013 BL 11987 (C.D. Cal. Jan. 14, 2013).

<sup>39</sup> *Id.* at \*2-3.

<sup>40</sup> 655 F.3d at 112.

<sup>41</sup> *Id.* at 1108-09; see also *Fait*, 655 F.3d at 111 (quoting Justice Scalia's example in summarizing the subjective falsity requirement).

would not be liable if the auditor honestly believed otherwise.

Further, the “no reasonable basis” standard should be rejected because, as one court has concluded, allowing for liability where there is no reasonable basis “turns every objectively false statement of belief into one that is also subjectively false.”<sup>42</sup> Indeed, under this standard, a plaintiff might be able to establish falsity by alleging that the auditor did not have a reasonable basis for its opinion regardless of whether the auditor genuinely believed its audit opinions when they were made. For instance, if there turned out to be a GAAP violation, an auditor’s GAAP opinion would be deemed to be false even if the auditor genuinely acted in good faith and believed its opinion at the time it was issued. Similarly, this standard is problematic for an auditor’s GAAS statements as it will result in extensive litigation regarding an auditor’s compliance with broad and largely judgmental standards, and it may result in falsity being

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<sup>42</sup> See *Lane v. Page*, 581 F. Supp. 2d 1094, 1127 (D.N.M. 2008) (rejecting “no reasonable basis” standard to the plead falsity of an opinion under *Virginia Bankshares*).

pleaded even where an auditor conducts a good faith audit, believes it has a basis for its audit opinion, and genuinely believes its audit opinion. Such a standard eradicates the subjective falsity element of *Virginia Bankshares*.

## VI. Conclusion

Over the next few years, more and more courts are likely to address the application of a subjective falsity standard to claims involving audit reports. The standard should be applied as articulated in *Belmont, Lehman Bros., Longtop, Buttonwood* and *Hufnagle* to require that plaintiffs among other things plead that the auditor did not genuinely believe its audit opinion. This approach appropriately recognizes that an auditor’s statements regarding GAAS and GAAP are not statements of verifiable fact, but instead statements of opinion. Further, under this standard, consistent with *Virginia Bankshares*, an auditor’s opinion will not be considered false where an auditor acts in good faith and genuinely believes its opinions based on the audit work performed.