BULL IN THE CHINA MARKET: THE GAP BETWEEN INVESTOR EXPECTATIONS AND AUDITOR LIABILITY FOR CHINESE FINANCIAL STATEMENT FRAUDS

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INTRODUCTION

Two known fraudsters start a company in China and decide to glean hundreds of millions of dollars from U.S. investors. So the fraudsters form an entity structure that escapes both Chinese and U.S. regulation, they have

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local bank branches lie about deposit and loan balances, and they move most of their expenses to an off-balance-sheet entity. With debts and expenses concealed, they report industry-leading margins, so Goldman Sachs and Morgan Stanley underwrite their U.S. initial public offering (IPO). They achieve a peak market capitalization of $2.4 billion dollars. They hire a leading audit firm to attest that their fraudulent financial statements fairly represent the company, but the audits are so obviously bad that a cottage industry of short-sellers—researchers who look for obvious frauds, buy short positions in them, and then expose the frauds on the Internet—notices the implausibility of the fraudsters' financial reports. The stock price crashes, prompting the auditors to review matters a little more closely. The auditors suddenly find fraud and publicly resign, renouncing their prior audits. Unsurprisingly, investors sue the auditors in addition to the company. Yet the suit cannot survive a motion to dismiss for failure to state a claim.

This was the case of *In re Longtop Financial Technologies Ltd. Securities Litigation* (Longtop).[1] It is one example in a long series of audacious Chinese securities frauds. This Note examines circumstances that have left U.S. capital markets especially vulnerable to frauds by U.S.-listed Chinese firms. As described in Part I, the Chinese market places less emphasis on the quality of financial reporting than the U.S. market and accordingly has less rigorous enforcement of reporting requirements. Efforts at cross-border regulation by the Securities and Exchange Commission (SEC) have failed to provide effective protection for investors in Chinese firms listed on U.S. exchanges. Where local and SEC enforcement efforts cannot protect investors, the only remaining protection for investors is the work of the independent auditor. U.S. investors in the Chinese market rely on audits performed by U.S.-branded audit firms.

Part II analyzes the dismissal of claims against Deloitte in the Longtop scandal, even though the plaintiffs possessed nearly perfect facts for a fraud action. Part III discusses the two major legal obstacles that frustrated the plaintiffs' attempt to state a claim against Deloitte. The first was that the elevated scienter pleading requirement of the Private Securities Litigation Reform Act of 1995 (PSLRA)[2] is an especially difficult hurdle for a securities fraud action against a foreign auditor of a foreign company. Direct evidence of scienter is unlikely to be available when both the auditor and the audited company are in China. The second legal obstacle was that

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1. 910 F. Supp. 2d 561, 567 (S.D.N.Y. 2012).

2. The PSLRA requires plaintiffs to plead with particularity facts giving rise to a "strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2) (2012).

the auditors' global network structure successfully isolates liabilities into individual member firms. Though the plaintiffs requested voluntary dismissal of their claims against Deloitte's international umbrella entity, existing law would have likely insulated it from any liability even if the claim had proceeded.

The Longtop example is another chapter of an old story. One hundred years ago, auditors certified the correctness of financial statements, but "certification" changed to "opinion" when they were exposed to potential liability to third parties relying on those statements. Nonetheless, after the Crash of 1929, certified public accountants (CPAs) were able to obtain an exclusive franchise over auditing in place of a proposed public agency takeover. Ever since, a long series of accounting scandals, from McKesson & Robbins to Enron, has slowly increased auditors' acceptance of a professional responsibility to detect fraud. Each scandal demonstrated inadequacy in the auditing function and in its regulation. Part IV places financial statement frauds based in China in this historical context.

Canadian capital markets too have been victimized by China-based securities frauds. Responding to both American post-Enron reform efforts and Supreme Court of Canada decisions restricting common law auditor liability, Ontario adopted a relatively successful statutory civil liability scheme. Part V examines the development of auditor liability in Canada. The effectiveness of the Canadian approach of exposing auditors to private liability is compared to that of the U.S. approach of cross-border regulation. In the case of Sino-Forest, Canadian investors received a record settlement, while in the case of Longtop, U.S. investors received nothing from the auditor.

Like prior scandals, China-based frauds should prompt reforms of the U.S. auditing profession to better protect the U.S. investor. Part VI suggests four reforms that would mitigate the issues that thwarted the fraud action brought by Longtop's investors. First, the PSLRA's heightened scienter-pleading requirement should be reformed. The PSLRA was intended to prevent domestic nuisance suits, not to shield foreign actors defrauding U.S. investors. Second, the role of scienter in the substantive standard of auditor liability to purchasers in the secondary market should be reconsidered. Third, the U.S. affiliate of a global accounting network should bear liability for co-affiliate's audits of foreign companies listed on U.S. exchanges. Auditors should not be able to extend their brands to audits of foreign companies listing in the United States without bearing any liability for the assurance reasonably given to investors by those brands. Fourth, U.S. auditors should face an increased scope of liability when they or their affiliates attest to the financial statements of U.S.-listed companies that are based in markets that do not fully cooperate with U.S. regulators.

I. FRAUD AND CHINA

The quality of financial reporting in the Chinese market is relatively low, and financial statement fraud is pervasive. There is also a major "regulatory hole" with respect to "variable interest entities" (VIEs), which evade U.S. regulators by being in China and avoid Chinese regulators by listing in the United States through a Cayman Islands-based entity.[3] U.S. investors in Chinese companies must therefore rely heavily on audits by U.S.-branded auditors. This reliance is big business for the auditors: the "Big Four" audit firms charged Chinese firms listed in the United States over $153 million in audit fees in 2010.[4]

The main financing sources of China's listed companies have been controlling shareholders and banks.[5] These entities possess and act on private information and, in the case of banks, take security interests in physical assets.[6] Accordingly, the Chinese stock market has less rigorous enforcement of financial reporting requirements than is typical of developed countries.[7] As a result, a high proportion of firms listed in Chinese stock markets receive modified audit opinions: between 1992 and 2006, 11% of China-listed firms received modified opinions, compared to only 2% of companies listed in other East Asian markets in the same period.[8] Auditors issue modified opinions when they believe the financial statements do not fairly present a firm's financial position.[9] A modified opinion suggests that the quality of the financial statements is "very poor."[10] However, in light of the traditional sources of financing for Chinese companies, receiving a modified opinion has had little effect on financing or investment available to these firms.[11] Thus the Chinese stock

3. *See infra* notes 22–29 and accompanying text.

4. Paul Gillis, *Who Audits China?*, CHINA ACCT. BLOG (Nov. 22, 2011, 10:56 PM), http://www.chinaaccountingblog.com/weblog/who-audits-china.html. The Big Four are PwC, Deloitte, EY (formerly Ernst & Young), and KPMG.

5. Zhiwei Lin et al., *Do Modified Audit Opinions Have Economic Consequences? Empirical Evidence Based on Financial Constraints*, 4 CHINA J. ACCT. RES. 135, 151 (2011).

6. *Id.*

7. *Id.* at 137.

8. *Id.* at 135. Modified audit opinions are those with explanatory paragraphs or opinions that are qualified, disclaimed, or adverse.

9. *Id.* at 152.

10. *Id.*

11. *Id.* at 136; *but see* Robert Czernkowski et al., *The Value of Audit Qualifications in China*, 25 MANAGERIAL AUDITING J. 404, 422 (2010) (finding a significant reduction in stock prices for companies receiving modified audit opinions accompanied by explanatory notes).

market places—or at least historically has placed—less emphasis on the quality of financial reporting, so the credibility of its financial reporting is lower—and audit opinions about that reporting are less valued—than it would be in the U.S. market.[12]

It is likely that these conditions continue when Chinese firms enter the U.S. market by listing on a U.S. stock exchange. The "bonding hypothesis" posits that becoming subject to U.S. regulation and enforcement, as well as to intermediaries such as debt raters, commits the cross-listing firm to fuller disclosure and respect for minority investors.[13] Yet this hypothesis is doubtful when applied to China: one recent study has found that "there is no evidence that cross-listing firms are superior to domestic Chinese firms in financial reporting quality."[14]

Moreover, within China, fraud is pervasive.[15] Recent financial statement frauds by Chinese firms listing in the United States have been particularly audacious.[16] In the two year period from 2011 to 2013, for example, Longtop Financial Technologies, China MediaExpress, China Sky One Medical, China Energy Savings Technology, ShengdaTech, China Values Technology, Sino-Forest Corporation (listed in Toronto), and China Integrated Energy each lost over 95% of its respective market capitalization following discovery of major financial statement frauds.[17] In 2010, almost half of all securities class actions filed against foreign issuers were brought against China-based companies listed on U.S. exchanges.[18] In the same period, there were at least forty-five New York Stock Exchange (NYSE) or NASDAQ delistings of Chinese companies, with another twenty-four

12. This is not to say that audit opinions are not valued at all by Chinese capital markets. *See* Z. Jun Lin et al., *Market Implications of the Audit Quality and Auditor Switches: Evidence from China*, 20 J. INT'L FIN. MGMT. & ACCT. 35 (2009) (presenting evidence that the Chinese stock market responds positively to firms that switch to a larger auditor).

13. John C. Coffee, *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1780–81 (2002).

14. Li Li Eng & Ying Chou Lin, *Accounting Quality, Earnings Management and Cross-Listings: Evidence from China*, REV. PAC. BASIN FIN. MARKETS & POL'YS, June 2012, at 1, 18.

15. *See* Stanley Lubman, *Fraud, Culture and the Law: Can China Change?*, WALL ST. J. CHINA REAL TIME (Aug. 24, 2012, 12:09 PM), http://blogs.wsj.com/chinarealtime/2012/08/24/fraud-culture-and-the-law-can-china-change/ (discussing, in the context of "a social and economic environment in which legal rules are as often as not disregarded," various recent frauds in China involving, among other things, fake medicine, fake Apple stores, and even fake military bases and fake prisons disguising the production of counterfeit cigarettes).

16. Floyd Norris, *The Audacity of Chinese Frauds*, N.Y. TIMES, May 26, 2011, http://www.nytimes.com/2011/05/27/business/27norris.html?pagewanted=all&_r=0.

17. YAHOO! FINANCE, http://finance.yahoo.com (get quotes search) (last visited Jan. 7, 2013).

18. David Bario, *Two (More) U.S. Listed Chinese Companies Are Hit with Securities Class Actions*, AM. LAW., Feb. 9, 2011, *available at* LEXIS ADVANCE.

facing imminent delisting.[19]

Though fraud is pervasive in China, Chinese regulations can nonetheless be onerous. For example, private Chinese companies need state permission to list overseas, and this permission was, until recently, difficult to acquire.[20] In addition, foreign investment is restricted in certain sectors, such as telecommunications and the Internet.[21] Chinese firms wishing to list in the United States can avoid these restrictions and escape Chinese regulation of financial reporting through the use of a VIE structure. In such a structure, a domestic entity, owned by a Chinese national, owns the substantive business.[22] Contractual agreements, rather than equity, transfer most of the economic interest in that entity to another Chinese entity that is a subsidiary owned by a foreign company, usually a Cayman Islands corporation.[23] The contractual agreements typically include a loan agreement, by which the foreign company capitalizes the domestic company; an equity pledge agreement that provides collateral under the loan agreement; a call option agreement allowing the foreign company to purchase the domestic company at any time; a power of attorney agreement giving all of the domestic company's shareholder rights

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19. *Chinese Delistings on U.S. Exchanges*, TRADING CHINA (Sept. 30, 2012), http://china.fixyou.co.uk/2012/09/chinese-delistings-on-us-exchanges.html.

20. *See* Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Gonggao [1999] 83 Hao: Zhong Guo Zhengquan Jiandu Guanli Weiyuanhui Guanyu Qiye Shenqing Jingwai Shangshi Youguan Wenti De Tongzhi (中国证券监督管理委员会公告 1999 83号：中国证券监督管理委员会关于企业申请境外上市有关问题的通知) [China Securities Regulatory Commission Announcement [1999] No. 83: Notice on Relevant Issues Concerning Enterprise Applications for Overseas Listing] (promulgated by the China Sec. Reg. Comm'n., July 14, 1999, effective July 14, 1999), *available at* http://www.csrc.gov.cn/pub/newsite/xxfw/fgwj/bmgz/200803/t20080305_77921.htm. These rules have been abolished and replaced by Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Gonggao [2012] 45 Hao: Guanyu Gufen Youxian Gongsi Jingwai Faxing Gupiao He Shangshi Shenbao Wenjian Ji Shenhe Chengxu De Jianguan Zhiying (中国证券监督管理委员会公告 2012 45号: 关于股份有限公司境外发行股票和上市申报文件及审核程序的监管指引) [China Securities Regulatory Commission Announcement [2012] No. 45: Guidelines for Supervising the Application Documents and Examination Procedures for the Overseas Stock Issuance and Listing of Joint Stock Companies] (promulgated by the China Sec. Reg. Comm'n., Dec. 20, 2012, effective Jan. 1, 2013), *available at* http://www.csrc.gov.cn/pub/csrc_en/laws/overRule/Announcement/201301/t20130106_220125.

21. Waishang Touzi Dianxin Qiye Guanli Guiding (外商投资电信企业管理规定) [Provisions on Administration of Foreign-Invested Telecommunications Enterprises] (promulgated by St. Council Decree No. 333, Dec. 11, 2001, effective Jan. 1, 2002, as amended Sept. 10, 2008, by St. Council Decree No. 534 (2008)), *available at* http://www.gov.cn/gongbao/content/2008/content_1102750.htm. In the law, the term "valued added services" includes many Internet services. *See* Lothar Determann, Internet Business Law in China for US Companies, BAKER & MCKENZIE, http://www.bakermckenzie.com/RRGoverningEBusinessInChinaOct09/ (last visited May 7, 2014).

22. Paul Gillis, *Accounting Matters: Variable Interest Entities in China*, GUEST SERIES (Forensic Asia Ltd., H.K., China), Sept. 18, 2012, at 4–5, *available at* http://www.chinaaccountingblog.com/vie_2012septaccountingmatte.pdf.

23. *Id.*

to the foreign company; and a technical service agreement, through which the foreign company extracts the profits of the domestic company.[24]

These agreements allow the domestic company to be consolidated into the financial statements of the Cayman Islands holding corporation, which lists on U.S. exchanges.[25] In 2010, 47% of NYSE and 65% of NASDAQ listings of Chinese firms used VIEs.[26] Since foreign investment in the Internet sector is restricted in China, eight of the largest ten VIE listings on U.S. exchanges are Internet companies.[27] By far the largest U.S.-listed Chinese VIE is Baidu—China's Google—with a market capitalization of over $40 billion dollars.[28] These Cayman Islands entities are considered foreign corporations not subject to Chinese regulation.[29] As U.S.-listed entities, they are subject to U.S. financial reporting regulations, but because the substantive business activities are in China, any audit must be conducted there, requiring Chinese cooperation.

This cooperation is lacking for any Chinese firm listed in the United States, including VIEs. China views U.S. regulatory oversight of Chinese auditors as a violation of Chinese sovereignty.[30] China also heavily regulates the transfer of documents out of China. China's "state secrets" laws may cover audit work papers and may require pre-approval from Chinese regulatory authorities before any disclosure to foreign regulators.[31]

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24. *Id.* at 5–6.

25. ACCOUNTING STANDARDS CODIFICATION § 810-10 (Fin. Accounting Standards Bd. 2009).

26. Paul Gillis, *Statistics on VIE Usage*, CHINA ACCT. BLOG (Apr. 11, 2011, 7:20 PM), http://www.chinaaccountingblog.com/weblog/statistics-on-vie-usage.html.

27. Gillis, *supra* note 22, at 1.

28. *Id.*

29. *Id.* at 7.

30. Patrick Chovanec, *The Clash of the Balance Sheets*, FOREIGN POL'Y, Dec. 10, 2012, http://www.foreignpolicy.com/articles/2012/12/10/China_accounting_scandal_SEC_Baidu.

31. Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Guojia Baomi Ju Guojia Dang'an Ju Zhengjian Hui GongGao (2009) 29 Hao: Guanyu Jiaqiang Zai Jingwai Faxing Zhengquan Yu Shangshi Xiangguan Baomi he Dangan Guanli Gongzuo De Guiding (中国证券监督管理委员会 国家保密局国家档案局—-证监会公告[2009] 29号：关于加强在境外发行证券与上市相关保密和档案管理工作的规定) [China Securities Regulatory Commission announcement No. 29 (2009): Provisions on Strengthening Confidentiality and Archives Administration in Overseas Issuance and Listing of Securities] (promulgated by the China Sec. Reg. Comm'n, Oct. 20, 2009, effective Oct. 20, 2009), *available at* http://www.gov.cn/gongbao/content/2010/content_1620613.htm ("[W]here overseas listed companies provide or publicly disclose documents, materials, or other items related to state secrets to the relevant securities companies, securities service institutions, and overseas regulatory authorities, the said companies shall apply for the approval of competent departments with the authority of examination and approval."). Article 9 of the Law on Guarding State Secrets defines state secrets as "matters which, if divulged, would harm national security and interests in the areas of politics, economics, national defense, and diplomacy." Zhonghua Renmin Gongheguo Baoshou Guojia Mimi Fa (中华人民共和国保守国家秘密法) [Law of the People's Republic of China on Guarding State Secrets] (promulgated by the Standing Comm. Nat'l People's Cong. Sept. 5, 1988, effective May 1, 1989, amended by the

The Public Company Accounting Oversight Board (PCAOB) has a statutory responsibility to inspect auditing of U.S.-listed companies that is conducted abroad.[32] The PCAOB has reached inspection agreements with regulators in most major economies but not with China.[33] The original deadline to complete these international inspections was extended from 2008 to 2009 and again to December 31, 2012.[34] The passing of the extended deadline raised the prospect of PCAOB deregistration of Chinese accounting firms, including the local affiliates of the Big Four. On November 29, 2012, PCAOB Chairman James Doty stated,

> [W]e have not been allowed to inspect any Chinese [auditing] firms that are registered with us, notwithstanding the fact that those firms continue to issue audit reports that are filed with the SEC and relied on by U.S. investors.
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> . . . .
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> At some point we must inspect [them] as part of our statutory duty . . . . The firms, by the way, have gotten themselves into a pickle.[35]

On May 7, 2013, the PCAOB and Chinese regulators concluded an agreement on enforcement cooperation.[36] The agreement allows PCAOB access to auditor work papers for specific investigations, but disclosure of work papers to private litigants requires preapproval from Chinese regulators.[37] The agreement does not allow PCAOB inspections of auditors. It also does not apply to the SEC, which at the time of the agreement had pending administrative proceedings charging the Chinese affiliates of each of the Big Four with violations of the Securities Exchange

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Standing Comm. Nat'l People's Cong. Apr. 29, 2010, effective Oct. 1, 2010) 2010 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 372. *But see* Declaration of Donald Clarke at 3, U.S. SEC v. Deloitte Touche Tohmatsu CPA Ltd., 928 F. Supp. 2d 43 (2013) (Misc. No. 11-512 GK/DAR) (expressing the opinion that, for off-site inspections, Chinese law does not require pre-approval and that an auditor could make a judgment for itself that its work papers contain no state secrets).

32. Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002 § 106, 15 U.S.C. § 7216 (2012), *amended by* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 §§ 929J, 982(g).

33. Stanley Lubman, *Single-Agency Oversight Could Help U.S.-China Auditing*, WALL ST. J. CHINA REAL TIME (Dec. 28, 2012, 6:01 PM), http://blogs.wsj.com/chinarealtime/2012/12/28/single-agency-oversight-could-help-u-s-china-auditing/.

34. PCAOB RULE 4003(g) (Pub. Co. Accounting Oversight Bd. 2011).

35. Michael Cohn, *PCAOB Chair Doty Warns Against Accounting Shortcuts*, ACCT. TODAY (Nov. 30, 2012), http://www.accountingtoday.com/news/PCAOB-Chair-James-Doty-Warns-Auditing-Shortcuts-64833-1.html.

36. Memorandum of Understanding on Enforcement Cooperation, U.S.-China, May 7, 2013, *available at* http://pcaobus.org/International/Documents/MOU_China.pdf.

37. *Id.* art. VII.

Act and the Sarbanes-Oxley Act for their refusal to provide the SEC with their audit work papers in relation to work performed for nine clients under investigation for fraud.[38] The proceedings could disqualify the firms from auditing U.S.-listed companies.[39]

Chinese companies that list on U.S. exchanges operate in a high fraud environment in which financial statements have low credibility. A great many Chinese firms listing in the United States also escape Chinese regulation through VIEs and escape U.S. regulation through China's reluctance to cooperate with U.S. regulators. Unsurprisingly, financial statement frauds are a major problem. For investors in U.S.-listed Chinese firms, a Big Four brand name may well be the only assurance against financial statement fraud available.

II. THE LONGTOP FINANCIAL TECHNOLOGIES FRAUD

Investors relied on the assurance of a Big Four brand name when they invested billions in Longtop. They lost everything, but the auditor escaped any liability. Examination of the Longtop fraud and the dismissal of claims against Longtop's auditor highlights the legal obstacles that investors face when they seek to hold auditors liable for failing to conduct a proper audit of a U.S.-listed Chinese firm. Paradoxically, the law makes it more difficult to hold auditors liable for poor quality audits in precisely the circumstances in which audit quality is the only available assurance against fraud.

A. The Longtop Fraud

Longtop is a Cayman Islands corporation with operations located in Xiamen, China, offering technology services to Chinese banks.[40] Through a VIE structure, Longtop held its IPO on the NYSE on October 25, 2007, and a secondary offering on November 23, 2009.[41] Longtop's external auditor was Deloitte Touche Tohmatsu CPA Ltd. (DTTC), Deloitte's China affiliate, which issued unqualified audit opinions on Longtop's financial statements and, in a prospectus filed with the SEC, consented to the use of its audit reports to support Longtop's security offerings.[42]

Citron Research is a short-selling firm that researches public company

38. BDO China Dahua CPA Co., Exchange Act Release No. 68,335, 105 SEC Docket 302 (Dec. 3, 2012) (instituting administrative proceedings). The SEC also charged the Chinese affiliate of BDO, the fifth-largest global auditor. *Id.*

39. *Id.* at 5.

40. *In re* Longtop Fin. Techs. Ltd. Sec. Litig., 910 F. Supp. 2d 561, 567 (S.D.N.Y. 2012).

41. Longtop Fin. Techs. Ltd., Prospectus Supplement (Form 424B5) (Nov. 17, 2009).

42. *In re Longtop Fin. Techs. Ltd. Sec. Litig.*, 910 F. Supp. 2d at 567.

financial disclosures, identifies companies with questionable financial reporting, takes a short position in them, and then discloses its research to the market.[43] On April 26, 2011, Citron Research published a report on its website stating, "It is the opinion of Citron that every financial statement [of Longtop] from its IPO to this date is fraudulent."[44] Citron noted that Longtop's gross and operating margins, 62.5% and 49%, respectively, greatly exceeded peer companies' gross and operating margins, which were 15–50% and 10–25%, respectively.[45] Longtop claimed that gross margins on its software sales were 90% and that it had achieved these margins through an outsourcing arrangement.[46]

Citron researched the outsourcing arrangement and discovered that the margins had been achieved by transferring operating costs to an off-balance-sheet entity, which had been excluded from Longtop's financial statements but was clearly a related party. As of March 31, 2010, Longtop had 4258 employees, 76% of whom were employed through a single human resources staffing company: Xiamen Longtop Human Resources Company (XLHRS).[47] Longtop was XLHRS's only customer.[48] Despite this, Longtop had no long-term contract with XLHRS, and XLHRS never solicited any other clients.[49] XLHRS had been formed five months before Longtop's IPO, was located in the same building as Longtop, and shared Longtop's email servers.[50] Finally, when the relationship between Longtop and XLHRS was challenged, Longtop terminated it and directly employed the employees formerly employed through XLHRS.[51]

The Citron report also raised questions about Longtop's leadership. Chairman Xiaogong Jia and Chief Executive Officer Weizhou Lian had previously been charged with fraud in Chinese proceedings.[52] Chairman Xiaogong Jia (also known as Ka Hiu Kung) claimed to have given 70% of his stock holdings, valued at approximately $250 million dollars, as a gift to employees and friends.[53] Citron expressed the opinion that this transaction in fact paid off Longtop's hidden liabilities or had some ulterior

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43. *Id.* at 568.

44. *Citron Reports on Longtop Financial*, CITRON RES. (Apr. 26, 2011), http://www.citronresearch.com/citron-reports-on-longtop-financial-nyselft/.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

motive.[54]

Release of this report caused Longtop's share price to decline by 26%.[55] Longtop responded with an investor call two days after the report's release.[56] During the call, Chief Financial Officer Derek Palaschuk denied any wrongdoing.[57] He pointed to DTTC's unqualified audit opinions and stated that those questioning Longtop's financials "were 'criticizing the integrity of one of the top accounting firms in the world.'"[58] He went on to say, "[T]he most important relations I have [are] with my family, my C.E.O., and then the next on the list is Deloitte as our auditor, because their trust and support is [sic] extremely important."[59]

Within a month of this conference call, DTTC resigned as Longtop's auditor, and the NYSE halted trading in Longtop's American Depositary Shares.[60] DTTC's resignation letter claimed that it had determined that further bank balance confirmations were necessary and that these further confirmations had revealed fictitious deposit balances and unreported loan liabilities.[61] On May 17, 2011, DTTC attempted to confirm balances through bank headquarters instead of local branches.[62] DTTC claimed that Longtop had obstructed this process by telling the bank headquarters that DTTC was not in fact its auditor and that it had detained DTTC audit files.[63]

DTTC was well aware that financial statement frauds involving forged bank statements and local bank branch collusion are common in China. China MediaExpress, also audited by DTTC, also engaged in this type of fraud.[64] Other examples include China Century Dragon Media, Inc., China Intelligent Lighting and Electronics, Inc., and NIVS Intellimedia Technology Group, Inc.[65] In the case of the China MediaExpress fraud, when DTTC requested that confirmations be made by the bank

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54. *Id.*

55. *In re* Longtop Fin. Techs. Ltd. Sec. Litig., 910 F. Supp. 2d 561, 568 (S.D.N.Y. 2012).

56. *Id.*

57. *Id.*

58. Norris, *supra* note 16.

59. *Id.*

60. *In re Longtop Fin. Techs. Ltd. Sec. Litig.*, 910 F. Supp. 2d at 568.

61. *Id.* at 568–69; *see also* Consolidated Class Action Complaint ¶ 48, *id.* (No. 11-cv-3658-SAS) (noting that another short-seller, Bronte Capital, questioned the secondary offering when the company had already had enough cash on hand to fund operations for 26 quarters).

62. Norris, *supra* note 16.

63. *Id.*

64. Paul Gillis, *Auditing Cash in China*, CHINA ACCT. BLOG (Apr. 20, 2011, 8:49 PM), http://www.chinaaccountingblog.com/weblog/auditing-cash-in-china.html.

65. *Id.*

headquarters and not the local branch, China MediaExpress refused, and DTTC resigned.[66] Likewise, in the case of the Longtop fraud, DTTC resigned as Longtop's auditor and declared Longtop's previous financial statements to be no longer reliable.[67]

B. Taking Deloitte to Court

Unsurprisingly, a securities class action was filed against Longtop, DTTC, and DTTC's umbrella entity, Deloitte Touche Tohmatsu CPA Ltd. (DTT).[68] The complaint alleged that DTTC had violated SEC Rule 10b-5 and that DTT had violated Section 20(a) of the Securities Exchange Act of 1934.[69] SEC Rule 10b-5 prohibits acts or omissions resulting in fraud or deceit in connection with the purchase or sale of any security.[70] Section 20(a) provides liability for persons who control persons who violate any provision of the Securities Exchange Act or any rule thereunder.[71] The complaint alleged that DTTC had recklessly failed to investigate Longtop's bank and loan balances adequately and had recklessly failed to detect the transfer of costs to the unreported related entity XLHRS.[72]

DTTC moved to dismiss for failure to plead a strong inference of scienter as required by the PSLRA.[73] The PSLRA imposes on plaintiffs both a heightened pleading standard and a stay on discovery pending resolution of a defendant's motion to dismiss.[74] Under the heightened standard, plaintiffs must allege "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[75] The Supreme Court held in *Ernst & Ernst v. Hochfelder*—nearly twenty years before the PSLRA—that scienter is the required state of mind for liability under Rule 10b-5.[76] Since that case, courts have consistently held

66. *Id.* That fraud was also exposed by Citron Research. Jason Raznick, *Is China MediaExpress a Fraud? Part 1*, FORBES, Feb. 7, 2011, 11:16 AM, http://www.forbes.com/sites/benzingainsights/2011/02/07/is-china-mediaexpress-a-fraud-part-1/.

67. *In re* Longtop Fin. Techs. Ltd. Sec. Litig., 910 F. Supp. 2d 561, 567 (S.D.N.Y. 2012).

68. *See infra* Part III.B (discussing DTT's function in the context of the *Parmalat* case).

69. *In re Longtop Fin. Techs. Ltd. Sec. Litig.*, 910 F. Supp. 2d at 566–67. Claims under Section 11 of the Securities Act of 1933 were not brought, presumably because the statute of limitations had run. *See infra* notes 364–69 and accompanying text.

70. 17 C.F.R. § 240.10b-5 (2014).

71. 15 U.S.C. § 78t (2012).

72. *In re Longtop Fin. Techs. Ltd. Sec. Litig.*, 910 F. Supp. 2d at 570.

73. *Id.* at 571–72.

74. § 101(b), 15 U.S.C. § 78u-4(b)(3)(B) (2012).

75. § 101(b), 15 U.S.C. § 78u-4(b)(2).

76. 425 U.S. 185, 212–15 (1976).

that recklessness satisfies the scienter requirement.[77] So, under the PSLRA, plaintiffs bringing Rule 10b-5 suits against auditors must plead particular facts creating a "strong inference" of auditor recklessness while discovery is stayed.

The court quickly disposed of plaintiffs' allegations that DTTC had failed to conform to Generally Accepted Auditing Standards (GAAS) when conducting its audit and that its failure had been so egregious as to amount to recklessness.[78] The plaintiffs characterized Citron's points about XLHRS as six "red flags" and alleged that even a "perfunctory review" would have revealed (1) that XLHRS had been formed shortly before Longtop's IPO, (2) that XLHRS had not been mentioned in Longtop's filings until 2009, (3) that XLHRS had occupied the same building with Longtop, (4) that XLHRS had shared the "Longtop" name, (5) that XLHRS had had no customers other than Longtop, and (6) that XLHRS had shared Longtop's email server.[79] They alleged that these "red flags" had been so obvious that DTTC must have been aware of them and had thus been reckless when it failed to address them in its audits.[80]

The court rejected this allegation with surprising reasoning. It found only three of those "red flags" to be so obvious that Deloitte must have noticed them: 1) XLHRS's formation shortly before Longtop's IPO, 2) an allegation that XLHRS had not been mentioned in Longtop's financials before 2009, and 3) the fact that XLHRS shared the name "Longtop."[81] One "red flag" excluded from this list is the fact that XLHRS shared the same building in Xiamen as Longtop. It is impossible to understand how this would not have been obvious to an onsite auditor.

Considering the three "red flags" it conceded as obvious, the court stated, "The fact that XLHRS was formed shortly before Longtop's IPO, and that it had 'Longtop' in its name, would not lead a reasonable auditor to suspect wrongdoing, given that this sort of staffing arrangement is common."[82] The court provided no argument or authority to support this statement, which lacks support because it is manifestly false: it is not at all common for a company to obtain three-quarters of its employees from an

77. *See, e.g.*, Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007) ("Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly . . . .").

78. *See infra* Part III.A (explaining that alleged nonconformity with professional standards fails to meet the scienter pleading requirement for Rule 10b-5 actions).

79. Consolidated Class Action Complaint, *supra* note 61, ¶¶ 135–36.

80. *Id.* ¶¶ 136–37.

81. *In re Longtop Fin. Techs. Sec. Litig.*, 910 F. Supp. 2d at 570.

82. *Id.* at 576.

unrelated entity that shares the company's name and building and that was formed immediately prior to the company's IPO. It is precisely because this is uncommon that Citron's research discovered that XLHRS was not an unrelated entity but instead a vehicle for concealing expenses. The court's offhand dismissal of the "red flags" as "red herrings"[83] is difficult to reconcile with the fact that those "red herrings" led Citron, a securities research firm, to invest its own money in short positions in the belief that they demonstrated Longtop to be a fraud.

The court refused to consider the short-seller reports as evidence supporting an inference of recklessness by Deloitte.[84] While they are certainly not dispositive on that question, the fact that the fraud was so obvious that a short-seller who had never been to China detected it even though professional, onsite audits over several years by a Chinese auditor operating under policies set by Deloitte failed to do so is surely circumstantial evidence supporting an inference of recklessness by DTTC.

The Longtop plaintiffs filed an amended complaint, with additional information obtained through discovery in proceedings against Mr. Palaschuk, but this was dismissed on April 8, 2013, for "the same defects laboriously identified in the Dismissal Opinion" and without leave for further amendment.[85] The court noted that the plaintiffs had failed to state a claim despite "access to copious discovery in crafting the Amended Complaint," despite the fact that the plaintiffs, like the SEC, had had no access to Deloitte's working papers.[86]

Section 20(a) claims against DTT were voluntarily dismissed without prejudice a few months before the dismissal of claims against DTTC.[87] Regardless, they necessarily would have been dismissed as well because the secondary liability claims against DTT under Section 20(a) were based on DTTC's alleged primary violation.[88] An SEC investigation against

83. *Id.* at 577.

84. *Id.* at 577–78.

85. *In re* Longtop Fin. Techs. Sec. Litig., 939 F. Supp. 2d 360, 392 (S.D.N.Y. 2013).

86. *Id.* Several months after the dismissal of claims against DTTC in Longtop, the SEC received "a substantial volume of documents . . . including the DTTC audit workpapers and certain other documents related to Longtop." SEC, Joined by Deloitte China, Files a Motion to Dismiss Without Prejudice the Subpoena Enforcement Action, Litigation Release No. 22,911, Accounting and Auditing Enforcement Release No. 3531 (Jan. 27, 2014), *available at* http://www.sec.gov/litigation/litreleases/2014/lr22911.htm. This occurred less than a week after an SEC administrative law judge suspended the affiliates of each of the Big Four firms. BDO China Dahua CPA Co. Ltd., Initial Decision Release No. 553 (ALJ Jan. 22, 2014), *available at* https://www.sec.gov/alj/aljdec/2014/id553ce.pdf.

87. Notice of Voluntary Dismissal Without Prejudice of Defendants Thomas Gurnee and Deloitte Touche Tohmatsu Limited at 1, *In re* Longtop Fin. Techs. Sec. Litig., No. 11-cv-3658-SAS (S.D.N.Y. Feb. 28, 2012).

88. A primary violator is a required by Section 20(a). 15 U.S.C. § 78t(a) (2012).

DTTC for its conduct in the *Longtop* case is ongoing as of January 2014.[89]

C. Why Deloitte Escaped the Possibility of Liability

The court concluded its opinion by finding that the facts alleged led to a "compelling and stronger inference that DTTC [had] performed a diligent audit, only to be duped by Longtop's fraud."[90] The plaintiffs lost under the PSLRA's heightened pleading standard for scienter. The court found it more compelling to assume Deloitte to be a victim of the fraud. In light of the facts of the case, this result seems stunning, and it is worth examining the factors that led to it.

The plaintiffs argued that DTTC was reckless in not identifying XLHRS as a related-party by 1) giving lengthy quotations from, and paraphrases of, auditing standards,[91] 2) repeating "red flags" identified by short-selling equities researchers, and 3) concluding that even a "perfunctory review" by DTTC would have exposed those flags."[92] DTTC's review, therefore, had been less-than-perfunctory. Since a less-than-perfunctory review is clearly inconsistent with auditing standards, the plaintiffs concluded that DTTC must have known that it was obligated to do more "to identify and conduct procedures aimed at uncovering related-party transactions"[93] and that DTTC had nonetheless recklessly failed "to undertake any meaningful investigation."[94]

This argument was inadequate. Nonconformity with auditing standards will not establish an inference of scienter.[95] Undoubtedly, plaintiff's counsel was hindered by the inability under the PSLRA to conduct discovery before pleading particular facts. But crucial details that would have explained why those "red flags" gave rise to a "strong inference" of scienter were omitted: for example, the definition of a related party or the fact that audits are onsite inspections (so that Deloitte must have known that XLHRS had shared a building with Longtop). Most importantly, instead of merely quoting professional standards, the plaintiffs could have also described the procedure by which an auditor performs a

89. *See* Litigation Release No. 22,911, *supra* note 86 (noting the delivery of documents "in connection with the SEC's investigation into possible fraud by DTTC's former audit client, China-based Longtop Financial Technologies Limited").

90. *In re Longtop Fin. Techs. Sec. Litig.*, 910 F. Supp. 2d at 581.

91. Consolidated Class Action Complaint, *supra* note 61, ¶¶ 123–34; *see also In re Longtop Fin. Techs. Sec. Litig.*, 910 F. Supp. 2d at 575–76, 581 (referring to "the Complaint's laundry list of auditing standards" and "general recitations of accounting standards").

92. Consolidated Class Action Complaint, *supra* note 61, ¶¶ 135–36.

93. *Id.* ¶ 136.

94. *Id.* ¶ 137.

95. *See infra* Part III.A.

review, pointing out the many ways in which a standard review procedure necessarily would have identified XLHRS as a related party and supporting an inference that DTTC had chosen not to review Longtop's accounts as required and therefore had acted with scienter.[96]

In addition, China's high-fraud reputation may have affected the court: operating in a perceived accounting battlefield might increase sympathy for auditors in fraud actions.[97] This sympathy could well be toxic when combined with the heightened scienter-pleading requirement's effect of forcing the court to speculate apologies for the defendant's behavior.

Furthermore, although the PSLRA does not distinguish between auditors and other defendants regarding scienter, courts often do.[98] They often assume auditors to be highly rational actors with no economic incentive to perform fraudulent audits.[99] A judicial presumption that auditors simply are not reckless is indeed a difficult hurdle for any plaintiff to overcome. This presumption may result from courts' failure to properly consider important features of the auditing industry, such as its oligopolistic nature and the revolving door connecting auditors with their clients.[100] The audit profession's seventy years of closing the "expectations gap" by lowering expectations that auditors should find fraud has been at least as important in creating the presumption against auditor recklessness.[101] A failure to discover fraud is not likely to create a "strong inference" of scienter when the expectation that fraud should have been discovered is low.

III. AUDITORS' LEGAL LIABILITY FOR FINANCIAL STATEMENT FRAUD

When auditors issue unqualified opinions to investors concerning a public company's fraudulent financial statements, they potentially face liability to persons using those statements. Investors may bring an action under SEC Rule 10b-5. The Securities Litigation Uniform Standards Act of 1998 confers on federal courts exclusive jurisdiction over class action

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96. For examples of procedures used to identify related parties and transactions with related parties, see RELATED PARTIES, Statement on Auditing Standards No. 122, §§ 550 (Am. Inst. of Certified Pub. Accountants 2012).

97. *See supra* Part I (describing pervasive fraud in China).

98. Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097, 1210.

99. *Id.* at 1174–76.

100. *Id.* at 1180–1202.

101. *See infra* Part IV.B.

suits involving listed securities and seeking damages on behalf of more than fifty people.[102] Auditors can also be subject to liability in a derivative shareholder action for a breach of their duty to the client corporation. Though a derivative action on behalf of a Chinese corporation[103] or liability to a bankruptcy trustee is possible in the aftermath of fraud orchestrated by senior management and enabled by auditor collusion or negligence,[104] these are beyond the scope of this Note. But within that scope are the two auditor-liability issues that thwarted Longtop's investors' claims. The first issue is the relation of the PSLRA's heightened scienter pleading requirement to auditor liability. The second is the legal structure of the auditing profession, which isolates liability to a single network affiliate. Ironically, the success of this structure in containing liability can be seen in *In re Parmalat Securities Litigation*,[105] a case in which a global auditing network was exposed to liability for the actions of a network affiliate.

A. Pleading Scienter

Rule 10b-5 actions have required an allegation of scienter since the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*.[106] Scienter is intent by the defendant to defraud.[107] The Court did not decide whether recklessness satisfies the scienter requirement, but subsequent decisions have held uniformly that it does.[108] What generally constitutes recklessness under Rule 10b-5 may not be clear,[109] but for auditors, a standard rooted in *Ultramares Corp. v. Touche*[110] has emerged as a consensus in the circuits.

Chief Judge Cardozo held in *Ultramares* that, although third parties

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102. Pub. L. No. 105-353, 112 Stat. 3227 (amending scattered sections of 15 U.S.C.).

103. *See* Batchelder v. Kawamoto, 147 F.3d 915, 922 (9th Cir. 1998) (holding that an American Depositary Receipt holder lacks standing to bring a shareholder derivative action on behalf of an overseas corporation when governing foreign law limits standing to shareholders of record); *infra* Part I (describing the variable interest entity structure commonly used, in lieu of direct listing, by Chinese firms listed in the United States).

104. For a recent and comprehensive treatment of such liability, see Christine M. Shepard, Note, *Corporate Wrongdoing and the* In Pari Delicto *Defense in Auditor Malpractice Cases*, 69 WASH. & LEE L. REV. 275 (2012).

105. 594 F. Supp. 2d 444 (S.D.N.Y. 2009).

106. 425 U.S. 185 (1976).

107. *Id.* at 193 n.12. The Court left open the possibility that recklessness can satisfy the scienter requirement. *Id.*

108. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007) ("Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly . . . .").

109. MELVIN ARON EISENBERG & JAMES D. COX, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 883 (10th ed. 2011).

110. 174 N.E. 441 (N.Y. 1932).

relying on an audit report could not bring tort actions against the auditors for negligence,[111] the auditors could, if they "acted without information leading to a sincere or genuine belief" and "closed their eyes to the obvious," be liable to those third parties for fraudulent misrepresentation.[112] The United States District Court for the Southern District of New York drew on *Ultramares* to define accounting recklessness as "[a] refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross."[113] The United States Court of Appeals for the Third Circuit also adopted the *Ultramares* line for reckless scienter in auditor liability cases post-*Hochfelder*: "It seems to us that the purpose of footnote 12 of the *Hochfelder* opinion was to preserve, at least in the context of accountants' liability, the standards of scienter developed in *Ultramares* . . . ."[114] For purposes of auditor liability, the *Ultramares* standard of scienter also satisfies the *Franke* standard of recklessness adopted in *Sundstrand*.[115] In *SEC v. Price Waterhouse*,[116] the Southern District of New York drew on *McLean*, *Sundstrand*, and other cases to hold that that an auditor is reckless only when

> the accounting practices were so deficient that the audit amounted to no audit at all, or "an egregious refusal to see the obvious, or to investigate the doubtful," or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.[117]

111. *Id.* at 447.

112. *Id.* at 449.

113. Jordan v. Madison Leasing Co., 596 F. Supp. 707, 710 (S.D.N.Y. 1984) (quoting State St. Trust Co. v. Ernst, 15 N.E.2d 416, 419). *State Street Trust Co.* cited *Ultramares*, 174 N.E. at 449, as the source of this definition. For another case adopting this standard in the Southern District of New York, see Axel Johnson, Inc. v. Arthur Andersen & Co., 762 F. Supp. 599, 601 (S.D.N.Y. 1991) (quoting Goldman v. McMahan, Brafman, Morgan & Co., 706 F. Supp. 256, 259 (S.D.N.Y. 1989)) ("[A]n egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of gross negligence which can be the functional equivalent of recklessness." (internal quotation marks omitted)).

114. McLean v. Alexander, 599 F.2d 1190, 1198 (3d Cir. 1979).

115. *Id.* Under the *Franke* standard, "reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719, 725 (W.D. Okla. 1976) (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 190 n.5 (1976); Beecher v. Able, Nos. 66 Civ. 3471, 66 Civ. 3382, 66 Civ. 3775, 1975 WL 420 (S.D.N.Y. Sept. 26, 1975); WILLIAM L. PROSSER, HANDBOOK OF THE LAW OF TORTS 185–86 (4th ed. 1971)). The Seventh Circuit adopted the *Franke* standard in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977).

116. 797 F. Supp. 1217 (S.D.N.Y. 1992).

117. *Id.* at 1240 (citations omitted).

The United States Courts of Appeals for the Sixth, Ninth, and Tenth Circuits have adopted this standard, which now appears to be the consensus standard for auditor recklessness.[118]

The PSLRA requires plaintiffs to plead with particularity facts giving rise to a "strong inference" of scienter.[119] This means facts that constitute direct evidence of scienter, circumstantial evidence of scienter, or the defendant's motive and opportunity to commit fraud.[120] In an action against an auditor of a foreign company, however, direct evidence of scienter is unlikely to be available, especially when both the auditor and the audited company are in China.[121] Nor is motive and opportunity likely to evidence scienter, since auditors generally do not buy or sell shares in the companies they audit.[122] So actions against auditors generally must plead detailed facts showing circumstantial evidence of scienter. Recognizing this, the Third Circuit in *McLean v. Alexander* noted that

> [c]ircumstantial evidence may often be the principal, if not the only, means of proving bad faith. A showing of shoddy accounting practices amounting at best to a "pretended audit," or of grounds supporting a representation "so flimsy as to lead to the conclusion that there was no genuine belief back of it" have traditionally supported a finding of liability in the face of repeated assertions of good faith, and continue to do so. In such cases, the factfinder may justifiably conclude that despite those assertions the "danger of misleading . . . (was) so obvious that the actor must have been aware of it."[123]

After the enactment of the PSLRA, the Supreme Court held in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* that the Act's heightened standard requires a court considering a motion to dismiss a complaint to first determine "whether *all* of the facts alleged, taken collectively, give rise to a

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118. *See* Dronsejko v. Grant Thornton, 632 F.3d 658, 665 (10th Cir. 2011); PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 693–94 (6th Cir. 2004); *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1426 (9th Cir. 1994).

119. § 101(b), 15 U.S.C. § 78u-4(b)(2) (2012).

120. EISENBERG & COX, *supra* note 109, at 884.

121. The PSLRA bars pre-trial discovery until after resolution of a motion to dismiss. § 101(b), 15 U.S.C. § 78u-4(b)(3)(B).

122. *See* CODE OF PROFESSIONAL CONDUCT ET § 101.02 (Am. Inst. of Certified Pub. Accountants 2013) (declaring that the independence of a CPA is considered impaired if he or she had any direct material financial interest in the client).

123. 599 F.2d 1190, 1198 (3d Cir. 1979) (quoting Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977); O'Connor v. Ludlam, 92 F.2d 50, 54 (2d Cir. 1937); Ultramares Corp. v. Touche, 174 N.E. 441, 447 (N.Y. 1931)).

strong inference of scienter."[124] If they do, the court must then engage in a "comparative inquiry" to determine "if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[125] Thus, courts must now engage in the "comparative inquiry" well before any trial. A showing of "shoddy accounting practices" no longer suffices even to get to discovery if opposing inferences can be proffered that, for some reason, appear more "compelling" to the judge deciding a motion to dismiss.

Under the PSLRA, plaintiffs must meet this fuzzy standard before proceeding to any pre-trial discovery. This limitation obviously reduces the likelihood of succeeding in an action against an auditor. Yet it is equally important that the recklessness standard adopted by the circuits does not hinge on professional standards. Hence, alleging failure to conform to professional standards will be insufficient to show scienter. Through *Hochfelder*'s footnote 12, the circuits have adopted Chief Judge Cardozo's standard from *Ultramares*, rather than the professional standards evolved in response to that standard.

B. Accounting Networks and Vicarious Liability

The largest auditors in the United States, the Big Four, are limited liability partnerships (LLPs) and members of global accounting networks. The LLP became available for U.S. auditors in the early 1990s in response to Texas lawsuits against lawyers and auditors, and now all large auditors are LLPs.[126] In an LLP, no partner has personal liability for malpractice claims against any other partner.[127] Internationally, audit firms organize as professional services networks of separate national firms.[128] Accounting firms achieved quick, global growth by using a model similar to franchising.[129] To expand into new national markets, firms contract with local firms.[130] The local firm receives a license to the international firm's trademark and other intellectual property and agrees to contribute money

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124. 551 U.S. 308, 322–23 (2007).

125. *Id.* at 324.

126. *See* Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1069–71 (1995) (describing the emergence of LLP legislation in response to suits against law firms and accounting firms after savings and loan failures in Texas).

127. UNIF. P'SHIP ACT § 306(c) (1997).

128. Occasionally, firms do span borders. For example, KPMG has merged many of its European and Middle Eastern member firms into KPMG Europe LLP. *See About*, KPMG EUROPE LLP, http://www.kpmg.com/eu/en/about/Pages/default.aspx (last visited Jan. 1, 2013).

129. Daniel Allen & Mindy Haverson, Note, *An Alternative Approach to Vicarious Liability for International Accounting Firm Networks*, 15 STAN. J.L. BUS. & FIN. 426, 429–30 (2010).

130. *Id.*

and support to the network and to maintain the standards of quality specified by network policies.[131] A separate international umbrella entity sets strategy, develops and implements policies, and promulgates brand and quality standards.[132] The umbrella entities of global accounting networks must exercise some amount of control over the member firms to which they have licensed their trademark.[133] If such control creates an agency relationship between the umbrella entity and member firms, the umbrella entity could be exposed to vicarious liability for the actions of its member firms under a "one firm" theory resting on agency law or controlling-person liability under Section 20(a). The largest network member might in turn face similar liability if it controls the umbrella entity.

This possibility became reality for Deloitte in the *Parmalat* case.[134] *Parmalat* appears to be an outlier, however. The great majority of cases on this issue teach that that the failure of one network firm to meet its duty to provide reasonable assurance against material misstatements in audited financial statements does not impose vicarious liability on its umbrella entity or on other network affiliates.[135]

Parmalat was a multinational Italian dairy corporation.[136] In the 1990s, it needed large amounts of cash to cover losses in South America and embezzlement by its chief executive officer and to service its debt.[137] Together with its auditor, Grant Thornton S.p.A., it created a scheme of fictitious transactions to hide its financial difficulties in order to obtain more loans.[138] But Italian law required Parmalat to rotate auditors in 1999.[139] Parmalat moved the fictitious transactions to a Caribbean entity for which Grant Thornton remained the auditor and hired Deloitte & Touche, S.p.A. (Deloitte Italy) as its auditor.[140]

Deloitte Italy is the Italian member of the Deloitte accounting network. Deloitte's international umbrella entity was Deloitte Touche

131. *Id.*

132. See *How We Are Structured: What is "PwC"?*, PWC, http://www.pwc.com/structure (last visited Jan. 1, 2013), for a description of the function of an umbrella entity and its relation to member firms. Deloitte also has an English private company umbrella entity. *About Deloitte*, DELOITTE, http://www2.deloitte.com/global/en/pages/about-deloitte/articles/about-deloitte.html (last visited June 22, 2014).

133. Allen & Haverson, *supra* note 129, at 431–32.

134. *In re* Parmalat Sec. Litig., 594 F. Supp. 2d 444 (S.D.N.Y. 2009).

135. *See infra* notes 150–52 and accompanying text.

136. 594 F. Supp. 2d at 447.

137. *Id.* at 447–48.

138. *Id.* at 448.

139. *Id.*

140. *Id.*

Tohmatsu (DTT), a Swiss verein headquartered in New York alongside Deloitte & Touche LLP (DT-US), Deloitte's U.S. member firm.[141] Despite the scale of the fraud, which included forged bank statements showing fictitious balances of several billion euros, Deloitte Italy continued to give Parmalat unqualified audit opinions.[142] Eventually, the scheme collapsed. DTT, DT-US, and the chief executive officer of DTT, among others, were sued in a securities class action in the Southern District of New York by purchasers of Parmalat securities in the period for which Deloitte had audited Parmalat.[143] The plaintiffs argued that DTT and DT-US were vicariously liable for Deloitte Italy's actions under Rule 10b-5 through the principle of *respondeat superior*, as well as under Section 20(a).[144]

The district court applied New York agency law to find that DTT had a principal-agent relationship with Deloitte Italy. It found that DTT exercised control in part because it controlled acceptance of client engagements by member firms, arbitrated disputes between them, and set policies and standards binding on the conduct of Deloitte Italy's client engagements.[145] Citing *Commercial Union Insurance Co. v. Alitalia Airlines, S.p.A.*, the court stated, "An agency relationship exists under New York law when there is an agreement between the principal and the agent that the agent will act for the principal, and the principal retains a degree of control over the agent."[146] However, the elements presented in *Commercial Union Insurance Co.* for such a relationship are "(1) the principal's manifestation of intent to grant authority to the agent . . . (2) agreement by the agent. . . . [, and (3)] the principal must maintain control over key aspects of the undertaking."[147] It is not obvious that DTT manifested an intent to grant authority to Deloitte Italy or that Deloitte Italy agreed to such a grant. The court's opinion did not address this question but instead focused on whether DTT controlled Deloitte Italy.

141. *Id.* at 447. A Swiss verein is a voluntary association form of legal entity intended for non-profit organizations but available for commercial purposes. Megan E. Vetula, Note, *From the Big Four to Big Law: The Swiss Verein and the Global Law Firm*, 22 GEO. J. LEGAL ETHICS 1177, 1181 (2009). It has limited liability among associates. *Id.* DTT is no longer a verein. Andrew Clark, *Deloitte Touche Tohmatsu Quits Swiss System to Make UK Its New Legal Home*, GUARDIAN, Sept. 20, 2010, 14:27 EDT, http://www.theguardian.com/business/2010/sep/20/deloitte-touche-tohmatsu-legal-registration-london.

142. 594 F. Supp. 2d at 447–48.

143. *Id.* at 449.

144. *Id.* at 447.

145. *Id.* at 455.

146. *Id.* at 451 (footnote omitted) (citing 347 F.3d 448, 462 (2d Cir. 2003); N.Y. Marine & Gen. Ins. Co. v. Tradeline, LLC, 266 F.3d 112, 122 (2d Cir. 2001)).

147. 347 F.3d at 462.

The court gave many examples of control over policy, public relations, legal affairs, and intra-network dispute resolution.[148] DTT had no authority, however, to direct or supervise any audit engagement conducted by any member firm.[149] Had DTT been unhappy with a member firm's conduct of an audit, it perhaps could have sanctioned that member according to the network agreements, but it could not have directed that the audit be conducted differently. For this reason, the court's finding on the question of umbrella-entity liability was contrary to many recent Southern District of New York decisions on the same question. In *In re Asia Pulp and Paper Securities Litigation*, the Southern District of New York held that Arthur Andersen's international umbrella entity did not have control over particular audits conducted by member firms; because it had no control over the transactions at issue, it had no liability for them under Section 20(a).[150] In *Nuevo Mundo Holdings v. Pricewaterhouse Coopers LLP*, the Southern District of New York found that PwC's global umbrella entity was not alleged to have been involved with decisions about how audit reports were completed and held that no principal-agent relationship existed.[151] In *In re WorldCom, Inc. Securities Litigation*, the Southern District of New York held that Arthur Andersen's and KPMG's respective umbrella entities did not have principal-agent relationships with primary-violator member firms because the umbrella entities lacked control over the members' business activities.[152]

The only case the *Parmalat* court cited against those contrary holdings was a case in a Florida state court: *Banco Espirito Santo International, Ltd. v. BDO International, B.V.*,[153] which relied on *Parker v. Domino's Pizza, Inc.*, a Florida decision concerning an automobile injury tort action.[154] The *Parker* court held that Domino's Pizza had possibly created an agency relationship with a franchisee because it had directed the franchisee's daily

148. *In re Parmalat Sec. Litig.*, 594 F. Supp. 2d at 452–53.

149. International umbrella entities do not practice accountancy. *See, e.g.*, *About Deloitte*, supra note 132 (stating that Deloitte's umbrella entity "does not provide services to clients"). Searching for Deloitte-branded registered auditors shows that Deloitte's umbrella entity is not registered to provide audit services even in its new UK domicile. *See* REGISTER OF STATUTORY AUDITORS, http://www.auditregister.org.uk/Forms/Default.aspx (last visited June 22, 2014).

150. 293 F. Supp. 2d 391, 396 (S.D.N.Y. 2003).

151. No. 03 Civ. 0613 GBD, 2004 WL 112948, at *3–6 (S.D.N.Y. Jan. 22, 2004).

152. No. 02 Civ. 3288(DLC), 2003 WL 21488087, at *10 (S.D.N.Y. June 25, 2003). Furthermore, in two cases in the 1980s, the Southern District of New York rejected the agency theory presented in *Parmalat*. *See In re* AM Int'l, Inc. Sec. Litig., 606 F. Supp. 600 (S.D.N.Y. 1985); Reingold v. Deloitte Haskins & Sells, 599 F. Supp. 1241 (S.D.N.Y. 1984).

153. 594 F. Supp. 2d at 453 n.63 (citing 979 So. 2d 1030, 1033–34 (Fla. Dist. Ct. App. 2008)).

154. 979 So. 2d at 1034 (citing 629 So. 2d 1026 (Fla. Dist. Ct. App. 1993)).

operations—particularly the acts of its drivers—in a substantial way.[155] The applicability of *Parker* in the international accounting context is highly questionable,[156] and the several decisions in the Southern District of New York on the question of vicarious liability within an international accounting network are more persuasive than *Banco Espirito Santo*.[157]

The plaintiffs in *Parmalat* also argued that DTT had liability under Section 20(a). Section 20(a) provides that persons

> who, directly or indirectly, control[] any person liable . . . shall also be liable jointly and severally with and to the same extent as such controlled person . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the [primary violation].[158]

The defendants argued that Section 20(a) requires control not only of the person but also of the transaction in question.[159]

The court found that DTT had liability under Section 20(a) on two grounds. It held that "the plain language of Section 20(a), requires control only of a person or entity liable under the chapter, not of the transaction constituting the violation."[160] If true, there would have been Section 20(a) liability since the court found that Deloitte Italy was an agent of DTT under New York agency law. Yet the circuits are split on the test for Section 20(a) liability. The Second, Third, and Fourth Circuits use the culpable-participation test[161] applied by the Southern District of New York in *Anwar*

155. *See* 629 So. 2d at 1027–28 (listing many examples of how Domino's Pizza did direct the activities of franchisees' drivers).

156. The Middle District of Florida notably refused to apply *Parker* when a car rental franchise was alleged to have provided a defective car in an automobile injury tort action, a fact pattern far closer to *Parker* than that in *Banco Espirito Santo*. Estate of Miller v. Thrifty Rent-A-Car Sys., Inc., 637 F. Supp. 2d 1029, 1042 (M.D. Fla. 2009).

157. There are two cases that might have been cited in support of *Parmalat* but for the Second Circuit's rule against citing unpublished opinions from unrelated cases from before 2007, but these are distinguished by their facts. *See* Teachers' Ret. Sys. of La. v. A.C.L.N., Ltd., No. 01 Civ. 11814(MP), 2003 WL 21058090 (S.D.N.Y. May 12, 2003) (allowing claims to proceed against BDO's umbrella entity where that entity was alleged to have signed the audit reports at issue); Cromer Fin. Ltd. v. Berger, Nos. 00 Civ. 2284(DLC), 00 Civ. 2498(DLC), 2002 WL 826847 (S.D.N.Y. May 2, 2002) (permitting a suit to proceed where a specific conveyance of actual authority was alleged); *see also* Colter Paulson, *Case Management in the Sixth Circuit: Unpublished Opinions*, SIXTH CIRCUIT APP. BLOG (Oct. 17, 2011), http://www.sixthcircuitappellateblog.com/news-and-analysis/case-management-in-the-sixth-circuit-unpublished-opinions/ (describing the Second Circuit rule).

158. 15 U.S.C. § 78t(a) (2012).

159. *In re* Parmalat Sec. Litig., 594 F. Supp. 2d 444, 455 (S.D.N.Y. 2009).

160. *Id.* at 456 (citing *In re* Parmalat Sec. Litig., 474 F. Supp. 2d 547, 554 (S.D.N.Y. 2007)).

161. Erin L. Massey, *Control Person Liability Under Section 20(a): Striking a Balance of Interests*

v. Fairfield Greenwich Ltd.,[162] an action related to the Bernie Madoff Ponzi scheme. There, the court held,

> [T]he question of whether a plaintiff must plead culpable participation to state a § 20(a) claim has, in this Court's view, largely been settled by the Second Circuit in numerous decisions, and that the weight of opinion of district courts concurs with the standard previously articulated and applied by this Court, the Court declines to apply *Parmalat*. Hence, in order to plead control, a plaintiff must plead that the defendant had actual control over the primary violator and transaction at issue.[163]

The culpable-participation test requires 1) that the defendant actually controlled the primary violator and 2) that the defendant culpably participated in the fraud.[164] Other circuits apply the potential-control test advanced by the *Parmalat* court.[165] The most widely adopted version of that standard requires 1) that the defendant exercised control "in general" over the primary violator and 2) "possessed the power to control the specific transaction upon which the primary violation is predicated."[166]

Perhaps because its reading of Section 20(a) did run directly against Second Circuit case law,[167] the *Parmalat* court also held that DTT might have had control of the transactions at issue (Deloitte Italy's audit opinions), so its liability under Section 20(a) did not hinge on whether Section 20(a) requires such control.[168] Under either test, however, Section 20(a) liability is dubious for the same reason that liability under a *respondeat superior* theory is dubious: DTT lacked the ability to control the conduct of any audit.

Plaintiffs also argued that DT-US had vicarious liability because it controlled DTT.[169] The court's reasoning on this issue is tenuous. It found

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for Plaintiffs and Defendants, 6 HOUS. BUS. & TAX L.J. 109, 114–15 (2005).

162. 728 F. Supp. 2d 372 (S.D.N.Y. 2010).

163. *Id.* at 425 (citation omitted).

164. Massey, *supra* note 161, at 114–15.

165. *Id.* at 118.

166. *Id.* (quoting Metge v. Baehler, 762 F.2d 621, 630–31 (8th Cir. 1985)) (internal quotation mark omitted).

167. *See* ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 108 (2d Cir. 2007) ("To establish a prima facie case of control person liability, a plaintiff must show (1) a primary violation by the controlled person, (2) control of the primary violator by the defendant, and (3) that the defendant was, *in some meaningful sense, a culpable participant in the controlled person's fraud*." (emphasis added)). The emphasized phrase originated in *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (en banc).

168. 594 F. Supp. 2d 444, 456 (S.D.N.Y. 2009).

169. *Id.* at 457.

no dispositive facts supporting the allegation that DT-US controlled DTT. It found only that DT-US partners held key leadership positions at DTT, that DT-US provided a large portion of DTT's funding, and that there had been a single instance in which DT-US "may have influenced DTT's decision making" on an issue entirely unrelated to audit practice.[170] This was not a persuasive finding of a principal-agent relationship in the context of a professional-services network. In such networks, it is very likely that several affiliates will provide partners for key leadership positions at the umbrella entity, will provide a large portion of its funding, and will influence its decision-making.[171] It is unlikely that the general circumstances characteristic of a professional services network are also a totality of circumstances establishing vicarious liability between affiliates. This view is consistent with the other decisions of the Southern District of New York.[172]

The decision in *Parmalat* to find vicarious liability under common law and under Section 20(a) for Deloitte's U.S. affiliate and for its umbrella entity is an anomaly in recent case law on vicarious liability in accounting networks. That Deloitte's vicarious liability survived a motion to dismiss can be seen as an aberration unlikely to have survived appeal. Under existing law and in the absence of unusual facts, actions against one affiliate will not result in liability for other affiliates or for the umbrella entity.

IV. AUDITORS' PROFESSIONAL RESPONSIBILITY FOR FINANCIAL STATEMENT FRAUD

A variety of actors rely on management-prepared financial statements to inform critical decisions: potential investors deciding whether to invest, current investors deciding whether to divest or to change management, financial institutions and trade suppliers deciding whether to extend credit

170. *Id.* at 458–59.

171. For example, all members of PwC's Network Leadership Team, which "sets the strategy and standards that the PwC network will follow" are senior partners of network affiliates with the exception of the chairman, Dennis M. Nally, who was the senior partner of the U.S. affiliate prior to becoming chairman of the global network. *Governance Structures*, PWC, http://www.pwc.com/gx/en/corporate-governance/governance-structures.jhtml (last visited May 12, 2014); *Network Leadership Team*, PWC, http://www.pwc.com/gx/en/corporate-governance/network-leadership-team-governance-structure.jhtml (last visited May 18, 2014); *Dennis M. Nally*, PWC, http://www.pwc.com/gx/en/leadership/dennis-nally.jhtml (last visited May 18, 2014).

172. *See* Nuevo Mundo Holdings v. Pricewaterhouse Coopers LLP, No. 03 Civ. 0613 GBD, 2004 WL 112948, at *3 (S.D.N.Y. Jan. 22, 2004) (rejecting similar arguments that the U.S. affiliates of PwC and Arthur Andersen had liability for their respective Peruvian network affiliates based on network connections without alleging any fact that would definitely show control).

and on what terms, current and potential customers or employees assessing the company's viability for doing business, and governments for computation of taxes, among other users.[173] Management has an incentive to supply only the information that it considers to be in its interests to supply, and market forces are unlikely to correct this in a timely fashion.[174] Regulation must therefore oblige management to produce financial statements that accurately provide the information needed by the users of its financial statements.[175]

For public companies, a major form of such regulation is the requirement of a financial statement audit, which is performed by CPAs under promulgated standards. A financial statement audit obtains and assesses evidence on whether a company's financial statements fairly represent its financial position.[176] Such audits must be conducted in accordance with GAAS.[177] The Sarbanes-Oxley Act, as amended, requires larger public companies in the United States to assess their internal controls over financial reporting and requires auditors to attest to those assessments.[178]

Thus, law and public policy reflect the expectation that auditors will detect financial statement fraud. This Part will consider, first, whether this is a reasonable expectation and, second, the history of the gap between this expectation, which Chief Justice Burger described as a "'public watchdog' function,"[179] and the auditing profession's own view of its responsibility. Over a century, reforms driven by accounting scandals have narrowed this gap. Scandals involving U.S.-listed Chinese companies are yet another episode in this history. Although the gap has narrowed—especially in the past twenty years—auditors have in the process obtained legal protections that effectively immunize them from liability for financial statement frauds by U.S.-listed Chinese companies.

173. JOHN FLOWER WITH GABI EBBERS, GLOBAL FINANCIAL REPORTING 69–71 (2002).

174. *Id.* at 73.

175. *Id.* at 75.

176. BOB LYKE, CONG. RESEARCH SERV., RS21120, AUDITING AND ITS REGULATORS: REFORMS AFTER ENRON 1–2 (2003).

177. *Id.* at 2.

178. Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002 § 404, 15 U.S.C. § 7262 (2012), *amended by* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 989G(a) *and* Jumpstart Our Business Startups Act § 103 (2012).

179. United States v. Arthur Young & Co., 465 U.S. 805, 818 (1984).

A. Is It Reasonable to Expect Auditors to Detect Financial Statement Fraud?

Users of financial statements, such as investors, expect audits to provide assurance against fraud. This expectation is reasonable because investors have good reason to believe that a properly conducted audit would detect major financial statement fraud.[180] GAAS prescribe a rigorous examination of the assertions made in a company's financial statements: an audit is more than a reconciliation of management-prepared reports with management-maintained records.[181] Auditors test details underlying asset and liability balances and transactions for existence, completeness, valuation, rights and obligations, and presentation.[182] They confirm bank balances with banks, receivables balances with customers, count physical inventory, examine contracts and vendor invoices, and confirm titles, among many other common tests, which, in one version of the standard, number about two hundred.[183] They perform analytical procedures to identify implausible or unexpected balances or transactions for scrutiny.[184]

The reliability of such audits in the U.S. market buttresses this expectation's reasonableness. One way to examine audit reliability is to count financial restatements. A financial restatement is the release of a previously-issued financial statement amended with new information correcting a material inaccuracy in the previous statement.[185] There is obviously no measurement of never-discovered material misstatements, but

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180. *See* Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707, 762–63 (2012) (connecting the notion of reasonableness to normative rules or principles and distinguishing between expectations supported by good reason and those supported by a right grounded in a rule or principle).

181. *See generally* OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH GENERALLY ACCEPTED AUDITING STANDARDS, Statement on Auditing Standards No. 122, § 200 (Am. Inst. of Certified Pub. Accountants 2012) (presenting the standards for the conduct of audits).

182. AUDIT EVIDENCE, Statement on Auditing Standards No. 122, § 500 (Am. Inst. of Certified Pub. Accountants 2012).

183. REPORTING ON INTERNAL ACCOUNTING CONTROL, Statement on Auditing Standards No. 30, § 326 (Am. Inst. of Certified Pub. Accountants 1980).

184. ANALYTICAL PROCEDURES, Statement on Auditing Standards No. 122, § 520 (Am. Inst. of Certified Pub. Accountants 2012).

185. See SUSAN SCHOLZ, DEP'T OF THE TREASURY, THE CHANGING NATURE AND CONSEQUENCES OF PUBLIC COMPANY FINANCIAL RESTATEMENTS: 1997–2006, at 7 (2008), *available at* http://www.treasury.gov/press-center/press-releases/Documents/FinancialRestatements_1997_2006.pdf, for the precise definition of a financial restatement event for purposes of the figures in this discussion. Changes in financial statements for reasons other than previous misstatements, such as adoption of new accounting standards, are not considered restatements. *Id.* Restatements of multiple periods resulting from the same restatement event are considered one restatement. *Id.*

a financial restatement indicates that at least one previous audit failed to discover that the financial statements did not fairly represent the financial position of the firm. In 2006, 6005 companies were listed on major American securities exchanges,[186] and those companies issued 594 restatements.[187] Thus, about 10% of listed companies in 2006 restated their financials for a prior period. This is a ten-fold increase from 1997, when only sixty-nine of the 7617 companies then listed (or 0.9%) issued financial restatements.[188]

However, the large increase in financial restatements from 1997 to 2006 resulted mostly from issues in accounting for expenses,[189] largely attributable to the implementation of internal control reporting under Sarbanes-Oxley, changes in accounting treatments of leases and stock options backdating, and the economic downturn following the end of the technology bubble.[190] It may also be due, in some degree, to more conservative auditing following the accounting scandals related to Enron, Global Crossing, and WorldCom.[191] For U.S.-listed companies, fraud restatements remain rare: twenty-one fraud restatements in 2006 (representing 0.3% of listed companies) compared to twenty in 1997.[192] By comparison, in China from 2000 to 2005, there were at least 271 fraud restatements, representing 3.7% of all companies listed on the Shanghai and Shenzhen exchanges.[193]

This low incidence of fraud restatements in the United States may seem surprising, given U.S. limits on auditor liability. However, U.S. markets have strong regulatory enforcement and place great value on financial reporting quality. Such elements are absent in the case of U.S.-

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186. *Number of Listed Companies*, WORLD FED'N EXCHANGES (2006), http://www.world-exchanges.org/statistics/annual/2006/number-listed-companies. Major American exchanges are defined as the NYSE, NASDAQ, and the American Stock Exchange.

187. Scholz, *supra* note 185, at 2.

188. *Id.* at 31; *Number of Companies with Shares Listed*, WORLD FED'N EXCHANGES (1997), http://www.world-exchanges.org/statistics/annual/1997/number-companies-shares-listed.

189. Scholz, *supra* note 185, at 31.

190. *Id.* at 2.

191. The audit firm in each of those scandals, Arthur Andersen, was quickly reduced from an 85,000-employee global accounting firm to a 150-employee business conference center outside of Chicago. Ameet Sachdev, *Conference Center Last Resort for Andersen*, CHI. TRIB. (May 22, 2003), http://www.chicagotribune.com/business/chi-0305220361may22,0,7603044.story.

192. Scholz, *supra* note 185, at 31.

193. Michael Firth et al., *Cooking the Books: Recipes and Costs of Falsified Financial Statements in China*, 17 J. CORP. FIN. 371, 375 (2011). The number of such restatements in each year of the period 2000–2005 is highly variable. *Id.* Firth et al. examined a sample of 271 restatements resulting from deliberate manipulation of financial statements, but the actual number of such restatements is likely higher because financial services firms were excluded from the sample. *Id.* at 376.

affiliated Chinese auditors auditing U.S.-listed companies, a situation in which auditors' professional standards of responsibility to detect fraud may be investors' only protection.

B. The Expectations Gap

Investors reasonably expect auditors to detect fraud, but auditors have historically disclaimed a responsibility to do so. Certainly, financial statements are the representations of management, not of the auditor. Yet every user of financial statements relies on the auditor's opinion as some degree of assurance against fraud.[194] This divergence between expected and accepted responsibility to detect fraud creates an expectations gap. Historically, the auditing profession has responded to this gap by attempting to lower expectations. But, as discussed below, these expectations drive much of the demand for auditors' services.[195]

In the 1910s and 1920s, auditor's reports certified the balance sheet as correct.[196] Although not required by law, audits were seen as the primary means of detecting fraud in financial statements.[197] Then, in 1931, *Ultramares* exposed auditors to liability to third parties relying on the auditor's report for fraudulent misrepresentation if the auditors "acted without information leading to a sincere or genuine belief."[198] The auditor's report at issue in *Ultramares* was a "Certificate of Auditors," issued for 1923, that "certif[ied]" the balance sheet and "further certif[ied]" that it presented "a true and correct view of the financial condition" of Fred Stern & Company.[199] Stern had fraudulently overstated its accounts receivable and other assets and had used the auditor's certification of the

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194. REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING 49 (1987).

195. For example, after the Enron and Global Crossing bankruptcies, Congress enacted the Sarbanes-Oxley Act to address concerns about the accuracy of public companies' financial disclosures. H.R. REP. NO. 107-414, at 18 (2002). The Act does this, in part, by requiring public companies to obtain an additional service from auditors: independent attestations of the companies' internal controls over financial reporting. Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002 § 404, 15 U.S.C. § 7262 (2012), *amended by* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 989G(a) *and* Jumpstart Our Business Startups Act § 103 (2012). By 2004, total audit fees for S&P 500 companies had increased by 103% from their 2001 levels. Jack T. Ciesielski & Thomas R. Weirich, *Ups and Downs of Audit Fees Since the Sarbanes-Oxley Act*, CPA J., Oct. 2006, at 28, 29, *available at* http://www.nysscpa.org/cpajournal/2006/1006/essentials/p28.htm (excluding four companies due to lack of available information).

196. PUB. CO. ACCOUNTING OVERSIGHT BD., ACAP COMMITTEE'S RECOMMENDATION RELATING TO THE AUDITOR'S REPORTING MODEL 4 (2010).

197. Stephen A. Zeff, *How the U.S. Accounting Profession Got Where It Is Today: Part I*, 17 ACCT. HORIZONS 189, 190–91 (2003).

198. *See supra* note 112 and accompanying text.

199. Ultramares Corp. v. Touche, 174 N.E. 441, 442 (N.Y. 1931).

overstated assets to obtain loans.[200] In finding auditor liability to the lender possible under a theory of fraudulent misrepresentation, Chief Judge Cardozo focused heavily on the word "certified."[201] In response to the *Ultramares* case, "certify" disappeared, and "guarantee" changed to "opinion" in the auditor's report language that was made mandatory for NYSE-listed companies in 1934.[202]

In response to the 1929 market crash, the Securities Exchange Act of 1934 required all registrants to have their financial statements audited by an independent CPA.[203] During the hearings on the Securities Act of 1933, a proposal to assign the external audit function to a government agency had been rejected—largely through the efforts of the president of the New York State Society of Certified Public Accountants—in favor of requiring audits by private CPA firms.[204] Thus, instead of creating a new regulatory agency, a public regulatory function was delegated as an exclusive franchise to accountants certified by a private institution and employed at private firms.

In response to the McKesson & Robbins auditing scandal in 1939, this private institution, the American Institute of Accountants (AIA, now the American Institute of Certified Public Accountants, or AICPA), began to issue bulletins establishing auditing procedures.[205] McKesson & Robbins perpetrated a financial statement fraud by overstating its accounts receivable and inventory.[206] The auditor, Price, Waterhouse & Co., failed to detect this fraud because its auditing procedures did not test these items.[207] The AIA, having resisted a government takeover of auditing only five years earlier, quickly responded by incorporating the performance of these tests into the professional standards for auditors.[208]

The AIA adopted a set of standards constituting GAAS in 1948.[209] Standards of Auditing Procedure (SAP) No. 30, adopted in 1951 (restated in 1960), disclaimed the responsibility to detect fraud. It stated that a financial statement audit "cannot be relied upon[] to disclose defalcations

200. *Id.* at 443.

201. *Id.* at 448 ("The defendants *certified as a fact*, true to their own knowledge, that the balance sheet was in accordance with the books of account. If their statement was false, they are not to be exonerated because they believed it to be true." (emphasis added)).

202. PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 196, at 4.

203. Zeff, *supra* note 197, at 192.

204. *Id.*

205. *Id.*

206. *Id.*

207. *Id.*

208. *Id.*

209. *Id.* at 193.

and other similar irregularities" and that assurance against fraud should instead be sought from "good internal control and fidelity bonds."[210] It also stated that an audit "cannot be relied upon to assure" the "discovery of deliberate misrepresentation by management" and that the "responsibility of the independent auditor for failure to detect fraud . . . arises only when such failure clearly results from noncompliance with generally accepted auditing standards."[211] This language limits the auditor's responsibility to assuring that the financial statements fairly summarize the financial records of the audited company. It encountered contemporaneous objection.[212] Certainly, "good internal control" is better suited to the detection of frauds such as defalcations by employees than the periodic audit of financial statements, but audits are expected to discover at least some types or magnitudes of fraud. In *Ultramares*, Chief Judge Cardozo's criticism of a failure to test receivables[213] reflected the clear expectation that an auditor should be held responsible for detecting some frauds if the audit itself is not to be deemed a fraud. After the McKesson scandal, testing receivables and inventory was made a professional responsibility precisely because auditors are expected to discover "deliberate management misrepresentation" of those assets.

Nonetheless, this language was repeated in the AICPA's superseding Statement of Auditing Standards (SAS) No. 1 in 1972.[214] In the late 1960s, decisions by the Southern District of New York in *Fischer v. Kletz*,[215] *Escott v. BarChris Construction Corp.*,[216] and *United States v. Simon*[217] had

210. RESPONSIBILITIES AND FUNCTIONS OF THE INDEPENDENT AUDITOR IN THE EXAMINATION OF FINANCIAL STATEMENTS, Statement on Auditing Procedure No. 30, ¶¶ 5–6 (Am. Inst. of Certified Pub. Accountants 1960).

211. *Id.* ¶ 5.

212. *See, e.g.*, R. K. MAUTZ & HUSSEIN A. SHARAF, THE PHILOSOPHY OF AUDITING 117 (1961) ("As a profession, independent auditing must accept appropriate responsibility, and it should do so in a positive and courageous fashion. One can have considerable sympathy with the profession's wish to avoid painful and expensive litigation yet believe that a more straightforward acceptance of responsibility is desirable.").

213. 174 N.E. 441, 443–44 (N.Y. 1931) (finding that an auditor examining Stern's accounts receivable "would have found invoices, seventeen in number, which amounted in the aggregate to the interpolated item, but scrutiny of these invoices would have disclosed suspicious features in that they had no shipping number nor a customer's order number and varied in terms of credit and in other respects from those usual in the business").

214. CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 1, §§ 110.05–.08 (Am. Inst. of Certified Pub. Accountants 1972).

215. 266 F. Supp. 180 (S.D.N.Y. 1967) (holding that an auditor could be liable for a breach of duty to investors for failure to disclose information acquired after audit completion).

216. 283 F. Supp. 643 (S.D.N.Y. 1968) (denying an auditor's affirmative due diligence defense against liability for misleading financial statements in a registration statement).

217. 425 F.2d 796 (2d Cir. 1969) (affirming the district court's criminal fraud conviction of three

greatly increased auditors' litigation exposure.[218] *Simon,* especially, was a blow to auditors' efforts to limit their liability for financial statement fraud. In *Simon*, three auditors were held criminally liable for securities fraud and mail fraud for certifying a misleading financial statement.[219] On review, the Second Circuit held that auditors could face criminal liability for attesting to materially misleading financial statements if the jury could reasonably infer that the auditors had acted in bad faith despite technical compliance with GAAS and Generally Accepted Accounting Principles (GAAP).[220] Three years later, the AICPA lost its GAAP rulemaking role with the creation of the Financial Accounting Standards Board (FASB).[221]

In 1973, only one year after SAS No. 1, Equity Funding Corporation of America collapsed[222] after the disclosure of accounting fraud so massive that the company had dedicated a mainframe computer system exclusively to fictitious transactions.[223] Nonetheless, the auditors had attested to the financial statements, and the fraud had gone undisclosed until an ex-employee tipped off a securities analyst.[224] Three auditors were convicted of fraud and sentenced to prison for failure to report evidence of the fraud.[225]

The AICPA responded to this and other pressures[226] in 1977 with SAS No. 16, which superseded SAS No. 1, sections 110.05–.08.[227] The disclaimer of responsibility from 1951 was replaced with ambiguous

auditors who had certified the fraudulent financial statements of Continental Vending Machine Corp.).

218. Zeff, *supra* note 197, at 197.

219. 425 F.2d at 798.

220. *Id.* at 805. Certiorari was denied on March 30, 1970. Simon v. United States, 397 U.S. 1006 (1970). President Nixon pardoned the defendants on December 20, 1972. *See* Wallace Turner, *Rebozo Identified as Helping Nixon to Buy Coast Land*, N.Y. TIMES, Aug. 28, 1973, at 1 (reporting concerns about the selection of the pardoned defendants' former firm, Coopers & Lybrand, to confirm the source of funding for the President's purchase of estates in California and Florida, then under investigation by the Ervin committee).

221. Zeff, *supra* note 197, at 198. FASB was created because of a general sense that auditors were representing the interests of their clients, rather than the public, in GAAP standard-setting. *Id.*

222. Dirks v. SEC, 463 U.S. 646, 650 (1983).

223. Rick Stelnick, *Mainframe: Madoff-Size Money, Monstrous Misapplication*, DECODED SCI. (Nov. 5, 2011), http://www.decodedscience.com/mainframe-madoff-size-money-monstrous-misapplication-loop/4927.

224. *Dirks*, 463 U.S. at 649.

225. *Three Auditors Get Jail in Equity Funding Case*, WALL ST. J., Jul. 17, 1975, at 31.

226. Such pressures included other accounting scandals, the Metcalf Committee, enactment of the Foreign Corrupt Practices Act, and a threat of more SEC regulation of auditing. Roland L. Madison, *SAS #82: Sword or Shield?*, NAT'L PUB. ACCT., Jan./Feb. 1999, at 20.

227. *See* THE INDEPENDENT AUDITOR'S RESPONSIBILITY FOR THE DETECTION OF ERRORS OR IRREGULARITIES, Statement on Auditing Standards No. 16 (Am. Inst. of Certified Pub. Accountants 1977).

language stating that the users of financial statements provide themselves with reasonable assurance against material misstatements by looking "to entities' controls," which include legal requirements, corporate governance, and internal accounting controls, "together with independent audits."[228] SAS No. 16 further qualified auditors' responsibilities by disclaiming responsibility to verify the completeness of the entity's records or to verify confirmations made by third parties.[229]

Dissatisfaction with auditors' resistance to accepting responsibility for detecting financial statement fraud continued in the 1980s with yet more accounting scandals.[230] In 1985, Congressman John Dingell publicly questioned "whether the S.E.C.'s delegation of its statutory authority [to establish standards used in audits] to self-interested private parties has adequately fulfilled the commission's mandate to protect the public interest."[231] In 1987, the Treadway Commission recommended that GAAS "should be changed to recognize better the independent public accountant's responsibility for detecting fraudulent financial reporting" and that the body issuing GAAS should include not only public accountants but also an equal number of persons "whose primary concern is with the use of auditing products."[232]

The AICPA quickly responded by issuing SAS No. 53 in February 1988.[233] Where SAS No. 1 had said that an audit "cannot be relied upon to assure" discovery of "deliberate misrepresentation by management," SAS No. 53 stated that an audit should be able to provide "reasonable assurance" against financial statement fraud.[234] Risk factors for fraud were identified.[235] The standard also attempted to lower expectations by qualifying "reasonable assurance" to exclude frauds involving forgery or collusion with third parties.[236]

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228. *Id.* ¶ 4.

229. *Id.* ¶¶ 11–13.

230. E.g., Penn Square, United American Bank, Drysdale Government Securities, Continental Illinois, and E.S.M. Government Securities. Michael S. Raab, *Detecting and Preventing Financial Statement Fraud: The Roles of the Reporting Company and the Independent Auditor*, 5 YALE L. & POL'Y REV. 514, 517 n.14 (1987).

231. John D. Dingell, *Who Audits the Auditors?: Congress Should Be the Watchdog*, N.Y. TIMES, Mar. 17, 1985, at F2.

232. REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING, *supra* note 194, at 13.

233. THE AUDITOR'S RESPONSIBILITY TO DETECT AND REPORT ERRORS AND IRREGULARITIES, Statement on Auditing Standards No. 53 (Am. Inst. of Certified Pub. Accountants 1988).

234. *Id.* ¶ 5.

235. *Id.* ¶¶ 10–13.

236. *Id.* ¶ 7.

Nonetheless, dissatisfaction continued. At the annual conference of the New York Society of CPAs in 1992, Assistant Comptroller General Donald Chapin "raised the specter of possible action by Congress to regulate the profession, and he warned the profession against continuing to close the expectation gap by reducing expectations."[237] He went on to say, "Expectations [of auditors] are so unbelievably low that some are questioning whether there is a role for a private sector profession. . . . [T]he profession's traditional function has been downgraded to a loss leader."[238]

Major audit firms, facing saturation of the market for their audit services, found rapid growth opportunities in non-audit consulting services.[239] They accordingly became even more sensitive to litigation risk from "loss leader" auditing services. In the 1990s, they further insulated themselves from liability when limited liability partnerships became available[240] and when the PSLRA both heightened pleading standards for Rule 10b-5 actions and limited joint and several liability to defendants who knowingly violate securities laws.[241] The auditing profession lobbied vigorously for the PSLRA's protections from shareholder actions.[242] Congress overrode President Clinton's veto to pass the PSLRA, but the auditors paid a price for this level of support: they were required to search for fraud.[243] Title III of the PSLRA requires audits to include procedures to provide reasonable assurance of detecting material fraud, to identify material related-party transactions, and to evaluate any doubts about the audited company as a going concern.[244] So, shortly after the enactment of the PSLRA, the AICPA replaced SAS No. 53 with a new standard, SAS No. 82,[245] which slightly strengthened SAS No. 53's language. It stated than an auditor is able to obtain reasonable assurance against financial

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237. Stephen A. Zeff, *How the U.S. Accounting Profession Got Where It Is Today: Part II*, 17 ACCT. HORIZONS 267, 276 (2003).

238. *Id.*

239. *Id.* at 277–79.

240. In 1992, when the AICPA changed Rule 505 of its Code of Professional Conduct to allow members to practice under any legal organization, only two states allowed LLPs. UNIF. P'SHIP ACT Addendum to Prefatory Note at 4 (1997). When LLPs were added to the Uniform Partnership Act in 1996, "over forty" states allowed them. *Id.*

241. § 101, 15 U.S.C. § 78u-4(b) (2012).

242. Zeff, *supra* note 237, at 278.

243. Abraham J. Briloff, *The Private Securities Litigation Reform from a Critical Accountant's Perspective*, 10 CRITICAL PERSP. ON ACCT. 267, 275 (1999).

244. § 301, 15 U.S.C. § 78j-1 (2012).

245. CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement on Auditing Standards No. 82 (Am. Inst. of Certified Pub. Accountants 1997).

statement fraud[246] and went into some detail to define "due professional care," "professional skepticism," and "reasonable assurance."[247] It also repeated the qualifications concerning forgery and collusion.[248]

The major accounting scandals in 2001 and 2002 made this a short-lived standard. In response to the Enron and Global Crossing scandals, the Sarbanes-Oxley Act created the PCAOB.[249] Every auditor of public companies must register with the PCAOB and comply with its rules and oversight.[250] In the same month that the first PCAOB members were appointed, SAS No. 99 superseded SAS No. 82.[251] It required auditors to gather and consider much more information than prior standards, and it required auditors to take initiative in identifying, considering, and responding to fraud risks.[252] The expectations gap persists, however, despite these reforms. Members of the PCAOB are divided between auditors (and accounting academics) and financial community users of financial statements.[253] The PCAOB still struggles with defining auditor responsibility, while the financial community remains dissatisfied.[254]

A century of accounting scandals forced the auditing profession to move from a disclaimer of responsibility to a qualified acceptance of responsibility for "reasonable assurance" against fraudulent misstatements, but in exchange auditors obtained, in LLPs and the PSLRA, protection from liability when they fail to provide such assurance. As seen in the *Longtop* case, these protections, combined with judicial unwillingness to infer scienter, give auditors near-immunity from investor claims arising from China-based financial-statement frauds, even when those frauds must

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246. *Id.* app. B ¶ 10.

247. *Id.* app. B.

248. *Id.* app. B ¶ 12.

249. Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002, Pub. L. No. 107-204, § 101, 116 Stat. 745, 750–53 (codified as amended at 15 U.S.C. § 7211).

250. *Id.*

251. CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement on Auditing Standards No. 99 (Am. Inst. of Certified Pub. Accountants 2002). This was superseded by SAS No. 122 on December 15, 2012, as part of the AICPA's Clarity Project to clarify audit standards and converge U.S. GAAS with international standards on auditing. *See* STATEMENTS ON AUDITING STANDARDS: CLARIFICATION AND RECODIFICATION, Statement on Auditing Standards No. 122 (Am. Inst. of Certified Pub. Accountants 2012).

252. CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, *supra* note 251, ¶¶ 11–36.

253. *See* Sarah Johnson, *What Is the Auditor's Role in Finding Fraud?*, CFO, Apr. 13, 2010, http://ww2.cfo.com/accounting-tax/2010/04/what-is-the-auditors-role-in-finding-fraud/ (noting that in response to a Treasury Department advisory group's recommendation, the PCAOB's advisory group, except for its investor members, "generally refrained from recommending" more detailed audits, citing complexity and the possibility of increased liability).

254. *See id.* (quoting PCAOB member Charles Niemeier) ("Investors are not satisfied with the status quo . . . and I think that is justified . . . .").

have been obvious to a diligent auditor. A century of accounting scandals has not made courts more likely to infer the scienter necessary for auditor liability. Instead, a persistent expectations gap about the usefulness of audits for detecting fraud has, ironically, helped to create a judicial presumption that auditors who fail to discover even flagrant financial statement frauds are not reckless but simply, in the words of the *Longtop* court, "duped."

V. CANADIAN REGULATION: A SUCCESS STORY

Canada does not have a national securities regulator.[255] Instead, each Canadian province has its own securities regulator. Because of the primacy of the Toronto Stock Exchange in the Canadian capital market, the Ontario Securities Commission is the most important Canadian securities regulator.[256] The common law of negligent misrepresentation, however, is controlled by the Supreme Court of Canada.[257] The court had once recognized that auditors owe investors a duty of care because of auditors' "public watchdog" role,[258] but in the late 1990s, echoing then-Chief Judge Cardozo's concern for imposing on auditors "liability in an indeterminate amount for an indeterminate time to an indeterminate class,"[259] the court concluded that shareholders can sue negligent auditors only through a derivative action.[260]

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255. Efforts to establish a federal securities regulator are ongoing. *See* Canadian Securities Regulation Regime Transition Office Act, S.C. 2009, c. 2, § 297 (establishing an office to lead the transition to a national securities regulator).

256. Ronald J. Daniels & Edward J. Waitzer, *Challenges to the Citadel: A Brief Overview of Recent Trends in Canadian Corporate Governance*, 23 CANADIAN BUS. L.J. 23, 29–30 (1994).

257. In Canada, auditors can be sued under a theory of either or both negligent misrepresentation or negligence *simpliciter*. In negligence *simpliciter*, "the duty of care is based solely upon proximity or 'neighbourship' in the Atkinian sense." Wooldridge v. Sumner, [1963] 2 Q.B. 43 at 69 (Diplock L.J.) (Eng.). A negligent misrepresentation action, unlike a negligence *simpliciter* action, allows recovery of pure economic losses. *Negligent Misrepresentation vs. Negligence* Simpliciter, LITIG. NOTES (Bersenas Jacobsen Chouest Thomson Blackburn LLP, Toronto, Ont., Can.), Jan. 2012, at 1, *available at* http://www.lexcanada.com/data/LitigationNotes_Vol7-1.pdf. Under a theory of negligent misrepresentation, however, plaintiffs must show reasonable reliance on the misrepresentation. *Id.* Under Canadian law this makes class certification in negligent misrepresentation actions difficult to achieve because reliance must be established individually for each class member. *Id.* However, it is less difficult when there is a strong claim of fraud against the issuer itself. *See* Ward K. Branch & Paul Miller, *Securities Class Actions and Secondary Liability in Canada: A New Day Dawning?*, *in* SECURITIES LAW: ADVANCED ISSUES—2009, § 1.2.7 (Continuing Legal Educ. Soc'y of B.C. ed., 2009), *available at* https://www.cle.bc.ca/PracticePoints/BUS/securities%20class%20actions.pdf. Major China-based securities frauds do present strong fraud claims; therefore, this Note does not address reliance issues in achieving class certification.

258. *See infra* Part V.A.

259. Ultramares Corp. v. Touche, 174 N.E. 441, 444 (N.Y. 1931).

260. *See infra* Part V.A.

Dissatisfaction with this evolution of tort law and reaction to U.S. reforms such as the Sarbanes-Oxley Act motivated Ontario to enact the Budget Measures Act,[261] an amendment to the Ontario *Securities Act* (OSA)[262] and other statutes. Like Sarbanes-Oxley, the Budget Measures Act granted regulators enhanced oversight powers over auditors and required issuers to certify their internal controls.[263] But more importantly, it introduced statutory civil liability for continuous disclosure in the secondary market in Ontario.[264] And while the U.S. regulatory and liability regimes have struggled to protect investors from China-based securities frauds, this new liability for continuous disclosure has been rather effective. The contrast between the outcomes of the frauds involving Longtop and Sino-Forest is nothing short of breathtaking. SEC and PCAOB efforts to regulate Deloitte in China have been ineffective: Longtop investors received nothing, and Longtop's auditor paid nothing. Meanwhile, in Canada, Ernst & Young was compelled to offer $117 million to settle claims arising from the Sino-Forest fraud.[265]

A. The Development of Canadian Tort Law on Auditor Liability

Auditor liability for negligent misrepresentation is a more recent concept in British and Canadian law than in American law, and, as in the United States, it is a concept built, in part, on the opinions of Benjamin Cardozo. In 1932, *Donoghue v. Stevenson*[266] removed the requirement of privity in English and Scots negligence actions.[267] Before that case, remedy for injuries arising from defective products that were not inherently dangerous had been available through actions for breach of the contract of sale.[268] The plaintiff, Mrs. Donoghue, had no contractual relationship with the seller or manufacturer of the ginger beer containing the infamous Paisley snail.[269] The House of Lords nonetheless held that she had a cause

261. Keeping the Promise for a Strong Economy Act (Budget Measures), S.O. 2002, c. 22.

262. Securities Act, R.S.O. 1990, c. S.5.

263. *Id.* §§ 143(1)25, 143(1)57–61.

264. *Id.* pt. XXIII.1.

265. Jeff Gray, *Ontario Court Approves $117-Million Settlement with Sino-Forest Auditors*, GLOBE & MAIL, Mar. 21, 2013, 1:48 PM EDT, http://www.theglobeandmail.com/report-on-business/industry-news/the-law-page/ontario-court-approves-117-million-settlement-with-sino-forest-auditors/article10044252.

266. [1932] A.C. 562 (H.L.) (appeal taken from Scot.).

267. Abed Awad, Comment, *The Concept of Defect in American and English Products Liability Discourse: Despite Strict Liability Linguistics, Negligence is Back with a Vengeance!*, 10 PACE INT'L L. REV. 275, 283 (1998).

268. *Id.*

269. [1932] A.C. at 562.

of action against the manufacturer.[270] The most expansive opinion in the case was that of Lord Atkin:

> You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure . . . . persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question.[271]

In support of his opinion, Lord Atkin referred to Cardozo's opinion in *MacPherson v. Buick Motor Co.*,[272] which, eighteen years earlier, had removed the requirement of privity in New York negligence actions and "in which [Cardozo] states the principles of the law as I [Atkin] should desire to state them."[273] But *Donoghue* only concerned physical damage resulting from negligence. The remedy for economic losses from reliance on misstatements remained in contract law, which, of course, required privity of contract.

In 1951, Sir Alfred Denning (later Lord Denning) argued for the extension of *Donoghue* to expose auditors to third-party liability for their negligent misstatements. In *Candler v. Crane*, *Christmas & Co.*, Henry Fraser was persuaded to invest £2000 in a mining concern on the basis of certified accounts that "gave an altogether false picture of the position of the company" because "there was no verification whatever by the accountants of the information which they were given."[274] The case turned on whether the auditors owed a duty of care to Fraser. Lord Denning argued in dissent that, under *Donoghue*, they did. He reasoned that accountants, as "persons who engage in a calling which requires special knowledge and skill," do owe a duty of care because "it is the duty of every artificer to exercise his art rightly and truly."[275] They owe this duty to their employer and "to any third person to whom . . . they know their employer is going to show the accounts, so as to induce him to invest money or take some other action."[276] But, citing *Ultramares*, he argued that this duty does not extend to persons to whom the audited company shows the accounts

270. *Id.*

271. *Id.* at 580.

272. 111 N.E. 1050 (N.Y. 1916).

273. *Donoghue*, [1932] A.C. at 598.

274. [1951] 2 K.B. 164 at 168 (Eng.).

275. *Id.* at 180 (quoting ANTHONY FITZHERBERT, LA NOVELLE NATURA BREVIUM 94D (1534)) (internal quotation mark omitted).

276. *Id.* at 180–81.

without the accountants' knowledge.[277] In 1964, in *Hedley Byrne & Co. v. Heller & Partners Ltd.*, the House of Lords overruled the *Candler* majority and adopted Lord Denning's dissent.[278]

Canadian law also adopted Lord Denning's dissent. *Haig v. Bamford* involved audited financial statements that induced Gordon Haig to invest cash and loan guarantees in a company.[279] Despite his investment, the company began to suffer cash flow problems.[280] Subsequent investigation showed that a prepayment had been improperly presented in the financial statements as revenue and should have been presented as a deferred revenue liability.[281] In fact, the company had not been not profitable at all: it was soon after liquidated by its creditors.[282] Haig sued the auditors of the financial statements.[283] The Supreme Court of Canada held that the auditor did owe a duty of care under tort law.[284] This duty rested not only on an ancient right of the public to expect experts to exercise their expertise "rightly and truly" but more importantly on the public role played by auditors in the modern economy. For the majority, Justice Dickson held that

> The increasing growth and changing role of corporations in modern society has been attended by a new perception of the societal role of the profession of accounting. The day when the accountant served only the owner-manager of a company and was answerable to him alone has passed. The complexities of modern industry combined with the effects of specialization, the impact of taxation, urbanization, the separation of ownership from management, the rise of professional corporate managers, and a host of other factors, have led to marked changes in the role and responsibilities of the accountant, and in the reliance which the

277. *Id.* at 183 (quoting Ultramares Corp. v. Touche, 174 N.E. 441, 444 (1932)) ("[I]t would be going too far to make an accountant liable to any person in the land who chooses to rely on the accounts in matters of business, for that would expose him to 'liability in an indeterminate amount for an indeterminate time to an indeterminate class.'").

278. [1964] A.C. 465 (H.L.) 502–03 (Lord Morris of Borth-y-Gest) (appeal taken from Eng.) ("I consider that it follows and that it should now be regarded as settled that if someone possessed of a special skill undertakes, quite irrespective of contract, to apply that skill for the assistance of another person who relies upon such skill, a duty of care will arise. . . . Furthermore, if in a sphere in which a person is so placed that others could reasonably rely upon his judgment or his skill or upon his ability to make careful inquiry, a person takes it upon himself to give information or advice to, or allows his information or advice to be passed on to, another person who, as he knows or should know, will place reliance upon it, then a duty of care will arise.").

279. (1976), [1977] 1 S.C.R 466, 469.

280. *Id.* at 470.

281. *Id.* at 470–71.

282. *Id.* at 471.

283. *Id.*

284. *Id.* at 483–84.

> public must place upon his work. The financial statements of the corporations upon which he reports can affect the economic interests of the general public as well as of shareholders and potential shareholders.[285]

The Supreme Court of Canada thus held—as the U.S. Supreme Court would hold eight years later[286]—that auditors owe a duty of care because of their "public watchdog" role: they are licensed to perform what is essentially a public regulatory function.

The court then inquired into the "proximity" of this duty. The use of "proximity" there originated in Lord Denning's dissent: to avoid the unlimited liability that concerned Chief Judge Cardozo in *Ultramares*, there must be something more than reliance to link the injured party to the auditor.[287] Lord Denning's proximity test asked whether "the accountants [knew] that the accounts were required for submission to the [investor] for use by him."[288] The Supreme Court of Canada, recognizing the public role of auditors, rejected this narrow proximity test. Instead, it held that when auditors prepare financial statements to guide a "specific class of persons" in a "specific class of transactions," they may be liable when that class of persons relies on their statements in engaging in that class of transactions.[289] The statements at question in *Haig* were prepared before Haig was known to be a possible investor.[290] The auditors in *Haig* knew, however, that the statements had been intended for a specific class of persons and a specific class of transactions: the "end and aim" of the statements had been to secure equity investors.[291] Therefore, the auditors could be liable to Haig, a member of the class of persons who had relied on the financial statements in making an equity investment.[292]

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285. *Id.* at 475–76.

286. *See* United States v. Arthur Young & Co., 465 U.S. 805, 818 (1984).

287. [1977] 1 S.C.R. at 476–77 (citing Ultramares Corp. v. Touche, 174 N.E. 441, 441 (1932)).

288. *Id.* at 477 (quoting Candler v. Crane, Christmas & Co., [1951] 2 K.B. 164 at 181 (Denning L.J.) (Eng.)).

289. *Id.* at 478 (quoting *Candler*, [1951] 2 K.B. at 184 (Denning L.J.)).

290. *Id.* at 470.

291. *Id.* at 478, 482. The "end and aim" phrase is adopted from yet another Cardozo opinion: Glanzer v. Shepard, 135 N.E. 275, 277 (N.Y. 1922).

292. *Id.* at 483; *see also Queen v. Cognos Inc.*, [1993] 1 S.C.R. 87, 110 ("[T]he doctrine of *Hedley Byrne* is well established in Canada . . . . The decisions of this Court . . . suggest five general requirements: (1) there must be a duty of care based on a 'special relationship' between the representor and the representee; (2) the representation in question must be untrue, inaccurate, or misleading; (3) the representor must have acted negligently in making said misrepresentation; (4) the representee must have relied, in a reasonable manner, on said negligent misrepresentation; and (5) the reliance must have been detrimental to the representee in the sense that damages resulted.").

Potential equity investors constitute a very large class of persons: the investing world at large. Liability to the world at large creates the possibility of liability out of proportion to fault. Thus, very shortly after *Haig*, the House of Lords expanded the proximity test: the *Anns* test asks first whether there is sufficient proximity between the plaintiff and defendant to create a prima facie duty of care and second whether there are policy considerations that negate this prima facie duty of care.[293] Although the House of Lords overruled *Anns* in 1991,[294] the Supreme Court of Canada affirmed it in 1997 in *Hercules Managements Ltd. v. Ernst & Young*.[295]

In *Hercules*, shareholders alleged that they had relied on negligent audit reports when investing in a company that subsequently went bankrupt.[296] The court held that, although rejected by the House of Lords, the *Anns* test had been adopted in Canadian law.[297] The Canadian *Anns* test asks,

> (1) is there a sufficiently close relationship between the parties (the [defendant] and the [plaintiff]) so that, in the reasonable contemplation of the [defendant], carelessness on its part might cause damage to that person? If so,
>
> (2) are there any considerations which ought to negative or limit (a) the scope of the duty and (b) the class of persons to whom it is owed or (c) the damages to which a breach of it may give rise?[298]

The court held that the auditors did owe a prima facie duty of care to the plaintiffs because their reliance on the audit reports was both reasonable and foreseeable.[299]

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293. Anns v. Merton London Borough Council, [1978] A.C. 728 (H.L.) 751–52 (appeal taken from Eng.).

294. Murphy v. Brentwood Dist. Council, [1991] 1 A.C. 398 (H.L.) (appeal taken from Eng.). Arguably, *Anns* had earlier been rejected in the auditing context by *Caparo Industries Plc. v. Dickman*, [1990] 2 A.C. 605 (H.L.) (appeal taken from Eng.). *See* Jack Blackier & Mindy Paskell-Mede, *Auditor Liability in Canada: The Past, Present, and Future*, 48 U.N.B.L.J. 65, 71–73 (1999) (discussing the relation between *Anns* and *Caparo Industries*).

295. [1997] 2 S.C.R. 165. For a discussion of the divergence between the House of Lords and the Supreme Court of Canada, see Blackier & Paskell-Mede, *supra* note 280.

296. *Hercules*, [1997] 2 S.C.R. at 175.

297. *See id.* at 184 ("It is now well established in Canadian law that the existence of a duty of care in tort is to be determined through an application of the two-part test first enunciated by Lord Wilberforce in *Anns v. Merton London Borough Council*.").

298. City of Kamloops v. Nielsen, [1984] 2 S.C.R. 2, 10–11.

299. *Hercules*, [1997] 2 S.C.R. at 200 ("[T]here can be no question that a *prima facie* duty of care was owed to the appellants by the respondents on the facts of this case.").

The second prong of the *Anns* test seeks to avoid liability out of proportion to fault by limiting the scope of the duty identified in the first prong.[300] The author of the unanimous majority opinion in *Hercules*, Justice La Forest, worried that exposing auditors to a broad duty of care would increase insurance costs, increase the time required to produce financial reports, and, ultimately, reduce the availability of auditing services.[301] So he limited the scope of liability by limiting the purpose for which audit statements should be used: "the only purpose for which the [audit] reports could have been used in such a manner as to give rise to a duty of care on the part of the [auditor] is as a guide for the shareholders, as a group, in supervising or overseeing management."[302] He distinguished *Hercules* from *Haig* by noting that in *Haig* the audit report in question had been prepared for the specific purpose of securing investors, whereas the reports in *Hercules* had been general annual reports.[303] Applying the rule of *Foss v. Harbottle*,[304] the court concluded that shareholders can sue negligent auditors only through a derivative action.[305]

B. The Ontario Securities Act: Part XXIII.1

In the 1990s, auditors in the United States obtained major protections from liability to investors with the introduction of the LLP and the enactment of the PSLRA.[306] Similarly, in the 1990s, auditors in Canada raised the specter of unlimited liability to avoid liability to investors who rely on their work. The *Hercules* court's conclusion that shareholders should not rely on audited financial statements drew a sharp reaction.[307]

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300. *See id.* at 202 ("[W]ere auditors such as the respondents held to owe a duty of care to plaintiffs in all cases where the first branch of the *Anns/Kamloops* test was satisfied, the problem of indeterminate liability would normally arise.").

301. Grace Hession, *Auditor Independence and Liability in Canada: Are We Ready for Third Party Liability?*, 36 U.B.C. L. REV. 575, 606 (2003).

302. *Hercules*, [1997] 2 S.C.R. at 207–08.

303. *Id.* at 191.

304. (1843) 67 Eng. Rep. 189 (H.L.) (appeal taken from Eng.) (holding that for wrongs alleged to have been done to a corporation, the proper claimant is the corporation itself).

305. *Hercules*, [1997] 2 S.C.R. at 211–14. Additionally, the Ontario Superior Court of Justice held that *Hercules Management* had foreclosed any "fraud on the market" theory for secondary market claims and that reliance must be established in all cases alleging negligent misrepresentation. Carom v. Bre-X Minerals Ltd. (1998), 41 O.R. 3d 780 (Can. Ont. Ct. Gen. Div.).

306. *See supra* Part III.

307. *See, e.g.*, Philip Mathias, *Auditors Not Legally Liable to Investors, Top Court Rules*, FIN. POST (Toronto), May 24, 1997, § 1, at 3 (quoting York University Professor Al Rosen) ("The annual financial statement is now a joke. . . . Who really needs an audit of financial statements that are not useful for investor decision-making?"); *Need New Securities Law That Holds Auditors Liable*, Editorial, FIN. POST., May 27, 1997, § 1, at 18 ("Provincial governments should quickly establish new securities law that makes a negligent auditor liable when investors lose money after relying on a company's

Soon thereafter, and in response to the Sarbanes-Oxley Act in the United States, Ontario introduced an amendment to the OSA, which, among other things, created civil liability for secondary market disclosures, codified at Part XXIII.1 of the OSA.[308] Previously, the OSA had imposed statutory liability only for misrepresentation in a prospectus, offering memorandum, or circular.[309] Part XXIII.1 allows investors to sue the issuer of a security and other responsible parties—specifically including auditors—if they acquire or dispose of the issuer's securities during a period when there is an uncorrected misrepresentation in a statement or document released by the issuer or during a period in which the issuer fails to make a timely disclosure of a material change.[310] Investors do not have to demonstrate actual reliance on such misrepresentations to seek damages.[311]

Part XXIII.1 provides a statutory scheme for calculating investor damages, including a provision for compensation for unrealized losses.[312] But damages are limited. There is a proportionate liability scheme: where there are multiple defendants, such as an auditor and the audited company, each defendant is liable only for the portion of the damages corresponding to that defendant's relative responsibility for those damages, except that defendants who meet an elevated scienter requirement in misrepresentation have joint and several liability with all other defendants who meet that scienter requirement.[313] There are also statutory caps on damages, except for defendants who meet the elevated scienter requirement.[314] An auditor's liability is limited to the greater of C$1 million or the revenue earned from the issuer and its affiliates in the twelve months preceding the misrepresentation.[315] Damages paid by defendants in related actions in other Canadian jurisdictions are creditable against the Ontario liability cap.[316]

audited financial statements.").

308. Securities Act, R.S.O. 1990, c. S.5, pt. XXIII.1. The Act was initially introduced in the Ontario Legislative Assembly as Bill 198 on October 30, 2002, and after a convoluted legislative process, Part XXIII.1 was proclaimed into force on December 30, 2005. Michael J. Willis, *Market Reaction to the Introduction of Shareholder Class Action Litigation: Evidence from Canada* 8–10 (Dec. 20, 2012) (unpublished Ph.D. dissertation, University of Pennsylvania) (on file with *Duke Journal of Comparative & International Law*).

309. *Id.* pt. XXIII.

310. *Id*. pt. XXIII.1, § 138.3.

311. *Id*. § 138.1.

312. *Id*. § 138.5.

313. *Id*. § 138.6.

314. *Id.* § 138.7.

315. *Id.*

316. *Id.*

Thus, a plaintiff suing an auditor under Part XXIII.1 has two options. If the plaintiff does not allege scienter, then he or she only need show that the financial statements contained a misrepresentation. But in such cases, the auditor's liability is proportionate to the auditor's level of fault and in any event capped at the greater of C$1 million or one year's audit fees. Or, if the plaintiff can show that the auditor acted with scienter, there is no limit to liability. To show scienter, the plaintiff must prove that the auditor "authorized, permitted or acquiesced" in or influenced the making of the misrepresentation while "knowing" that it was a misrepresentation.[317]

Part XXIII.1 provides several statutory defenses. The defenses most relevant to auditors of financial statements are: (1) an exemption from liability for forward-looking information, such as pro forma financial statements, if that information includes certain cautionary language and (2) a reasonable investigation, or due diligence, defense.[318] The due diligence defense bars liability where an auditor can prove that it conducted a reasonable investigation and that it had no reasonable grounds to believe that there was a misrepresentation.[319] This is an affirmative defense: auditors are presumptively liable for misrepresentations and bear the burden of proving the due diligence of their audits.[320]

Finally, Part XXIII.1 suits cannot commence without leave of the court.[321] The court must be satisfied that the action is brought in good faith and that there is a reasonable possibility of success.[322] This provision is an attempt to prevent frivolous suits. Additionally, Part XXIII.1 avoids "strike suits" by providing that the prevailing party is entitled to costs.[323] Unlike in the United States, where the PSLRA attempts to prevent frivolous suits by raising the pleading standard required to state a claim at all,[324] Part XXIII.1 attempts to prevent frivolous suits by assessing the merits of the claim at the earliest stage and by granting costs to the prevailing party.

From 2006 to 2011, thirty-four Part XXIII.1 actions were filed.[325] By December 2012, nine of those cases had settled and twenty-five were pending.[326] Every settled case settled for an amount exceeding C$1

317. *Id.*
318. *Id.* § 138.4.
319. *Id.*
320. *Id.*
321. *Id.* § 138.8.
322. *Id.*
323. *Id.* § 138.11.
324. *See supra* Part III.A.
325. Willis, *supra* note 308, at 4.
326. *Id.* at 28.

million: the total of all settlements against all defendants—not just auditors—was C$68.35 million, and the average settlement was approximately C$8.5 million.[327] Then, in 2013, Ernst & Young settled the Sino-Forest case for C$117 million.[328]

C. The Sino-Forest Fraud

Sino-Forest Corporation (Sino-Forest) was a Chinese forestry company registered in Ontario and headquartered in Hong Kong.[329] It went public in Alberta through a reserve takeover in 1994, and in 1995 it listed on the Toronto Stock Exchange.[330] On June 2, 2011, its share price plummeted when Carson Block of Muddy Waters, LLC, alleged that Sino-Forest had fraudulently inflated its assets and earnings.[331] Muddy Waters, like Citron Research, which exposed the Longtop fraud, is a short-selling firm that researches public company financial disclosures, identifies companies with questionable financial reporting, takes a short position in them, and then discloses its research to the market.[332] It specializes in Chinese frauds.[333]

Muddy Waters reported that Sino-Forest was "the granddaddy of China RTO [reverse takeover] frauds."[334] It "was engaged in aggressive fraud from the time it went public."[335] It used undisclosed "authorized intermediaries," which were actually related entities, to fabricate sales and to exaggerate assets.[336] One of these intermediaries had as its registered address an empty field in a fishing village.[337] Most of Sino-Forest's revenues came from these intermediaries, allowing Sino-Forest to claim a

327. *Id.*

328. Peter Koven, *Judge Approves Ernst & Young Settlement for Sino-Forest Shareholders*, FIN. POST (Toronto), Mar. 20, 2013, http://business.financialpost.com/2013/03/20/judge-approves-ernst-young-settlement-for-sino-forest-shareholders/.

329. Andy Hoffman & Mark Mackinnon, *The Roots of the Sino-Forest Mystery*, GLOBE & MAIL (Toronto), Sept. 13, 2011, 5:45 PM, http://www.theglobeandmail.com/globe-investor/the-roots-of-the-sino-forest-mystery/article594111/?page=all.

330. *Id.*

331. Statement of Allegations, ¶ 10, *In re* Ernst & Young LLP, Ontario Securities Commission (Dec. 3, 2012), *available at* http://www.osc.gov.on.ca/documents/en/Proceedings-SOA/soa_20121203_ernst-young.pdf.

332. Hibah Yousuf, *How Muddy Waters Spots Fraud in China*, CNN MONEY (May 2, 2012, 9:39 AM ET), http://money.cnn.com/2012/05/02/markets/muddy-waters-carson-block/.

333. *Id.*

334. MUDDY WATERS, LLC, REPORT ON SINO-FOREST CORPORATION 1 (2011), *available at* http://d.muddywatersresearch.com/wp-content/uploads/2011/06/MW_TRE_060211.pdf.

335. *Id.* at 4.

336. *Id.* at 1.

337. *Id.* at 1, 27.

gross margin of fifty-five percent.[338] Its financial claims, like those of Longtop, were audacious in their obvious implausibility. For example, its claimed Yunnan province sales would have exceeded harvesting quotas sixfold and would have required over 50,000 log-transporting trucks.[339] Sino-Forest used an opaque offshore structure—at least twenty entities incorporated in the British Virgin Islands—to conceal its fraud.[340] Sino-Forest was audited by Ernst & Young's Canadian entity, Ernst & Young LLP.[341] Concerning the quality of Ernst & Young's audits, Muddy Waters Research said that Sino-Forest's "board of directors appears to be the retirement plan for former Ernst & Young partners."[342]

Muddy Waters estimated that Sino-Forest's shares were worth less than $1 per share.[343] On May 27, 2011, Sino-Forest's shares closed at $18.39 per share.[344] The day after Muddy Waters Research released its report, they closed at $5.23 per share.[345] On August 26, 2011, the Ontario Securities Commission suspended trading in Sino-Forest shares because the company had engaged in fraud: its shares then became worthless.[346] On January 10, 2012, Sino-Forest announced that its financial statements and audit reports should not be relied on.[347] On March 30, 2012, Sino-Forest filed for bankruptcy.[348]

On June 20, 2011—only eighteen days after Muddy Waters released its report—a pension fund holding Sino-Forest shares filed suit against Sino-Forest, Ernst & Young, and many other defendants.[349] The fund alleged, regarding Ernst & Young, negligent misrepresentation and statutory claims under Part XXIII.1, among other things.[350] On December

338. *Id.* at 1.

339. *Id.* at 2.

340. *Id.* at 33.

341. *Id.* at 2.

342. *Id.*

343. *Id.* at 3.

344. GOOGLE FINANCE, http://www.google.com/finance (get quotes search) (last visited Nov. 9, 2013).

345. *Id.*

346. Christopher Donville, *Sino-Forest Trading Halted as OSC Rescinds Order That Executives Resign*, BLOOMBERG NEWS (Aug. 26, 2011, 4:52 PM ET), http://www.bloomberg.com/news/2011-08-26/sino-forest-executives-ordered-to-resign.html.

347. Statement of Allegations, *supra* note 331, ¶ 14.

348. *Sino-Forest Files for Bankruptcy Protection*, BBC NEWS (Mar. 30, 2012, 17:58 ET), http://www.bbc.co.uk/news/business-17569840.

349. Notice of Action, Trs. of the Labourers' Pension Fund of Cent. & E. Can. v. Sino-Forest Corp., 2012 ONSC 2937 (Can. Ont.) (No. CV-11-429003-00CP).

350. Fresh as Amended Statement of Claim, *Trs. of the Labourers' Pension Fund of Cent. and E. Can.*, 2012 ONSC 2937 (No. CV-11-431153-00CP).

3, 2012, the Ontario Securities Commission filed charges against Ernst & Young, alleging that its audits constituted a breach of section 78 of the OSA.[351] That same day, Ernst & Young settled the Part XXIII.1 suit for C$117 million.[352] The settlement was approved on March 20, 2013.[353]

The contrast with the Longtop litigation is shocking. In the United States, a shareholder suit under Rule 10b-5 arising from an audacious China-based securities fraud could not survive a motion to dismiss. The investors received nothing, and the auditors paid nothing. In Canada, a shareholder suit arising under Part XXIII.1 from an audacious China-based securities fraud proceeded and, eighteen months later, settled for a record-breaking amount. Three points of comparison are particularly notable:

1) Vicarious liability was not an issue in the Sino-Forest case because the auditor was Ernst & Young's Canadian affiliate.

2) The Ontario Securities Commission's charges, filed against Ernst & Young on December 3, 2012, probably influenced Ernst & Young's decision to offer a settlement that same day. On the same December 3, 2012, the SEC filed administrative proceedings against Deloitte for failing to provide the SEC with audit working papers related to Chinese companies—including Longtop, certainly—trading on U.S. markets. But that had no impact on the Longtop litigation: the amended complaint was dismissed on April 8, 2013. The court stood by its amazing conclusion that Deloitte had "performed a diligent audit, only to be duped by Longtop's fraud."[354]

3) The Canadian plaintiff in the Sino-Forest fraud did not need to show scienter to state a claim—scienter, if shown, would have simply removed the statutory limit on damages. To proceed, the plaintiff needed only to persuade the court that the claim was meritorious. But the U.S. plaintiffs in the Longtop fraud were required to allege scienter by pleading with particularity facts giving rise to a "strong inference" of scienter.[355] As discussed in Part III.A, it is nearly impossible for a U.S. plaintiff alleging China-based fraud to do this. Even the SEC could not obtain Deloitte's work papers from China until well after the dismissal of the Longtop plaintiffs' claims against Deloitte.

351. Statement of Allegations, *supra* note 331, ¶ 65.

352. Kevin LaCroix, *E&Y Settles Ontario Sino-Forest Securities Suit for $117 Million*, D&O DIARY (Dec. 4, 2012), http://www.dandodiary.com/2012/12/articles/securities-litigation/ey-settles-ontario-sino-forest-securities-suit-for-117-million/.

353. Gray, *supra* note 265.

354. *In re* Longtop Fin. Techs. Ltd. Sec. Litig., 910 F. Supp. 2d. 561, 581 (S.D.N.Y. 2012).

355. 15 U.S.C. § 78u–4(b)(4) (2012).

VI. LESSONS FOR THE UNITED STATES

U.S. and Canadian auditor liability regimes had certain similarities, pre-Enron. Both had developed, by the late 1990s, to a point at which it was virtually impossible to show auditor fraud. In the United States, auditors received protections from liability to investors under the PSLRA. In Canada, tort law developed in a way that limited investors to derivative suits against corporate auditors—problematic when the corporation itself is a fraud.

After Enron, however, U.S. and Canadian regulation took markedly different approaches. Under Sarbanes-Oxley, the United States focused on increasing regulatory oversight of auditors. Ontario also increased regulatory oversight of auditors but additionally created a statutory civil liability regime. When confronted with China-based securities frauds, the U.S. model has not protected investors well. It bears noting, again, that Sino-Forest's auditor was the Canadian affiliate of Ernst & Young, but Longtop's auditor was the Chinese affiliate of Deloitte. Nonetheless, it is impossible to compare the results of litigation against Longtop and Sino-Forest and conclude that investors in U.S. capital markets are as well protected from China-based frauds as are investors in Canadian markets. An auditor providing an audit opinion for a Chinese company listed in Toronto surely feels more performance pressure from potential legal liabilities than an auditor providing an opinion for a Chinese company listed in New York.

The U.S. experience with frauds by U.S.-listed Chinese firms, when considered alone and when considered in comparison with recent Canadian experience, suggests at least four possible reforms to better protect U.S. investors. First, the PSLRA and *Tellabs* go too far in requiring scienter to be effectively proven before discovery. *Tellabs* requires courts to dismiss complaints against auditors of U.S.-listed Chinese firms unless the allegations give rise to such a strong inference of scienter that no reasonable person could imagine any compelling inference to the contrary. But at that stage the auditor always can (and will) say, "It's China—we were duped too." Under *Tellabs*, the court must decide whether this is a compelling inference before discovery—i.e., before the auditor must produce the work papers and other documents that establish whether the auditor was in fact "duped." It is difficult to see how, at the Rule 12(b)(6) stage, courts can make informed decisions that the inference of auditor scienter is more or less compelling than the inference that the issuer's fraud overcame the auditor's diligence when the underlying events—the transactions being audited and the audit itself—take place in China.

Courts need to screen claims for merit prior to commencement of expensive trials of those claims. This is recognized both in the heightened pleading requirements of the PSLRA and in Part XXIII.1's leave-of-the-court requirement. The heightened pleading standards of the PSLRA, however, are particularly difficult in cases alleging reckless audits in China. The standard effectively forces courts to search for an apology for the auditor. Cases alleging fraud on the other side of the world may present the imagination with too much scope. A judge in Manhattan inferring what happened in China from advocacy by New York lawyers is not anchored in the contextual reality of the case in anything like the degree to which he or she is when inferring what happens on Wall Street. In the context of Chinese audits, the pleading standard amplifies the impact of skilled advocacy and reduces the impact of the facts of the case.

For example, in the Longtop case, the Southern District of New York concluded, "DTTC performed a diligent audit, only to be duped by Longtop's fraud."[356] This was supported, in significant part, by the finding that Longtop's arrangement with XLHRS "would not lead a reasonable auditor to suspect wrongdoing, given that this sort of staffing arrangement is common."[357] "Given that this sort of staffing arrangement is common" is obviously a finding of fact on a material fact in dispute, despite the Rule 12(b)(6) posture of the case. And it is an erroneous finding of fact.[358] But how would the court know? The adversarial system assumes that the court will be informed by counsel representing the litigants,[359] but this is unlikely to be effective before the litigation begins in earnest. The PSLRA pleading standard invites factual findings without a record because courts must gauge the plausibility of competing explanations for alleged facts to make a determination as to whether those alleged facts give rise to a "strong inference" of scienter before the parties may develop the factual record. In effect, auditor due diligence becomes a pleadings issue: instead of being an affirmative defense for which the auditor bears the burden of proof, as under Ontario's Part XXIII.1, it is a hypothetical excuse that an auditor may proffer before anything is proven.

Courts screening complaints against auditors to decide which ones should be litigated at least to the point of an answer need to be informed by some background subject matter expertise. It therefore might be wise for courts to use a special master possessing such expertise. Originally, special

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356. *In re Longtop Fin. Techs. Sec. Litig.*, 910 F. Supp. 2d. at 581.

357. *Id.* at 577.

358. *See supra* Part II.B.

359. *E.g.*, Penson v. Ohio, 488 U.S. 75, 84 (1988) ("This [adversarial] system is premised on the well tested principle that truth—as well as fairness—is 'best discovered by powerful statements on both sides of the question.'" (citation omitted)).

masters appointed under the Federal Rules of Civil Procedure heard trial testimony and reported recommended findings of fact "when the issues [were] complicated."[360] Since 2003, special masters can be used under Rule 53 to assist any pre-trial or post-trial role if the parties consent.[361] Special masters have been used to hear Rule 12(b)(6) motions in federal and state courts.[362] Removing the necessity of the parties' consent for the use of a special master could allow a court to appoint a master to report recommendations to the court concerning the "plausibility" of a complaint alleging auditor negligence.

Second, making scienter an element of the substantive standard for auditor liability imposes too high of a burden on plaintiffs. Clearly, auditors must be protected from "liability in an indeterminate amount for an indeterminate time to an indeterminate class."[363] In the United States, this has come to mean that liability can only be had against an auditor under Rule 10b-5 if the auditor acted with scienter. Ontario's Part XXIII.1 sensibly accomplishes this protection through its cap on damages absent proof of scienter. The comparison of the Longtop scandal in the United States with the Sino-Forest scandal in Canada suggests that the Canadian policy better serves the public policy goal of protecting investors.

Even in U.S. securities laws, scienter is not always a requirement for liability. For example, Section 11 of the Securities Act of 1933[364] does not require scienter and in some situations is an available action against auditors involved in financial statement frauds.[365] But Section 11 primarily protects investors in the primary market by imposing liability for misstatements in registration statements.[366] Although it is available to purchasers on secondary markets, 1) it requires purchasers to trace the purchase back to the initial offering, 2) it requires purchasers to show reliance on the registration statement where they bought securities more than one year after the registration statement and the issuer had already distributed financial statements, and 3) its statute of limitations requires actions to be brought no later than three years after the security at issue was

360. Shira A. Scheindlin & Jonathan M. Redgrave, *Special Masters and E-Discovery: The Intersection of Two Recent Revisions to the Federal Rules of Civil Procedure*, 30 CARDOZO L. REV. 347, 348 (2008) (quoting FED. R. CIV. P. 53(b) (1938) (amended 2003)).

361. *Id.* at 352.

362. *See, e.g.*, Askew v. Sec'y of Health & Human Servs., No. 10-767V, 2012 WL 2061804 (Fed. Cl. May 17, 2012); Stop & Shop Cos. v. Fisher, 444 N.E.2d 368 (Mass. 1983).

363. Ultramares Corp. v. Touche, 174 N.E. 441, 444 (N.Y. 1931).

364. 15 U.S.C § 77k (2012).

365. DONNA M. NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS 271 (3d ed. 2012).

366. *Id.* at 271–72.

first offered to the public.[367] Longtop held its IPO on October 24, 2007, and a secondary offering on November 17, 2009.[368] The fraud was exposed on April 26, 2011.[369] Thus, the statute of limitations had run with respect to the 8.5 million shares issued through Longtop's IPO but not the 4.25 million shares issued through the secondary offering. To have standing to sue under Section 11, the Longtop plaintiffs would have had to trace their shares to the secondary offering registration statement and to prove that their purchase decisions had relied on that statement and not on Longtop's subsequent fraudulent financial statements.

Hence, the purchasers of Longtop securities, like any secondary market purchaser duped by a financial statement fraud undetected for a few years, needed to prove scienter to have recourse against the auditor on whom they had relied for protection against financial statement frauds. Instead, Deloitte's repeated attestations to the veracity of Longtop's financials only served to prolong the fraud to the point that scienter had to be proven. As noted above, when the audit takes place in China, it is perhaps impossible even to plead scienter adequately. But pleading standards aside, it is not clear what public interest is served by making scienter a substantive requirement for auditor liability to secondary market purchasers. Why should auditors receive greater protection from liability regarding long-standing financial statement frauds over successive Form 10-Qs than from liability regarding similar but nascent frauds on a Form S-1?

Third, a domestic accounting network affiliate should bear vicarious liability for foreign affiliates' audits of companies listed on domestic exchanges. Investors look to U.S. audit firms for assurance regarding financial statements for companies listed on U.S. exchanges. Auditors should not be allowed to defeat this reasonable expectation through organization as an international network of affiliates trading under the same name as the U.S. firm. After all, "[t]he prospect of liability . . . constitutes 'one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular [audit] engagement.'"[370] It would be in the public interest if this prospect of liability were to prevent trusted auditors from extending their brand into new markets in which they are

367. *Id.* at 272–73. 334–35.

368. Consolidated Class Action Complaint, *supra* note 61, ¶¶ 39–40.

369. *Id.* ¶ 44.

370. Deborah A. DeMott, *Further Perspectives on Corporate Wrongdoing,* In Pari Delicto*, and Auditor Malpractice*, 69 WASH. & LEE L. REV. 339, 350 n.52 (2012) (quoting Codification of Financial Reporting Policies § 602.02.f.i, Fed. Sec. L. Rep. (CCH) ¶ 73,274 (2009)) (describing the SEC's view on auditor liability).

more certain of their ability to collect audit fees than of their ability to attest to financial statements. Perhaps the easiest way to accomplish this would be to require the U.S. affiliate of a global audit firm to "sign" any audit opinions or similar statements used in SEC filings, analogously to the practice of using a locally-admitted lawyer to file briefs drafted by out-of-state lawyers. After all, it does seem incongruous to rely on audit firms beyond the reach of the SEC, such as DTTC, to ensure the accuracy of SEC filings.

Fourth, the scope of auditor liability could be made inversely contingent on the effectiveness of cross-border SEC regulation. The current standoff between the SEC and Chinese regulators shows that cross-border regulation by the SEC is not always an available substitute for auditor liability. In markets such as China, where local authorities resist SEC supervision and investigation of auditors,[371] U.S. investors are less protected, and the public policy need to expose auditors to liability to investors is correspondingly greater. Therefore, it may be beneficial to increase the scope of auditor liability—ideally, the scope of liability for the auditor's U.S. affiliate—in those markets.

For example, in markets where the SEC cannot effectively investigate auditors, scienter will be almost impossible to show. If the SEC cannot obtain auditor work papers, or if the SEC can obtain those work papers only after months or years of tense, high-level negotiations, then there is no reason to suppose that a private litigant could timely obtain those work papers. Exposing auditors to greater liability in the U.S. market for audits occurring in markets beyond the SEC's reach—for example, by removing any statutory cap on liability, if one existed—would have several potentially salutary effects. It would cause U.S. audit firms to supervise the operations of affected local affiliates much more closely. It would also give U.S. audit firms great hesitation in extending their brand to markets in which they cannot provide assurance services meeting U.S. market expectations. Finally, and most importantly, it would incentivize them to pressure local authorities to come to an agreement with the SEC.

CONCLUSION

Auditors are private parties granted an exclusive right to perform a public regulatory function. The Supreme Court held unanimously that "the independent auditor assumes a *public* responsibility transcending any employment relationship with the client."[372] Auditors' professional

371. *See supra* note 30 and accompanying text.

372. United States v. Arthur Young & Co., 465 U.S. 805, 817 (1984).

standards, however, do not protect the investing public's reasonable expectations with regard to Chinese entities listed on U.S. exchanges. Those standards have developed from the self-interested responses of the auditing profession to public criticisms of its failures to perform its public function adequately. Nor does the law concerning auditor liability protect the investing public's reasonable expectations. Instead, it provides the auditing profession near-immunity from investor complaints.[373] Protecting the public's reasonable expectations requires exposing auditors to at least the possibility of liability when their public audits fail to meet those expectations. The value of "tinkering with liability standards" is not to compensate investors for their losses—securities class action suits generally fail to compensate investors—but to provide "a sober reminder that financial frauds will be aggressively pursued by well-armed and resourceful private attorney[s] general[]."[374]

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373. *See* Alison Frankel, *The Near-Impossible Standard for Showing Auditor Fraud* REUTERS, Apr. 9, 2013, *available at* http://blogs.reuters.com/alison-frankel/2013/04/09/the-near-impossible-standard-for-showing-auditor-fraud/ (citing the *Longtop* decision as evidence of the near-impossibility of an investor class successfully stating a fraud claim against an auditor).

374. JAMES D. COX, STATEMENT SUBMITTED TO THE ADVISORY COMMITTEE ON THE AUDITING PROFESSION, U.S. DEPARTMENT OF TREASURY 4 (2007).