

## The Second Circuit Clarifies Liability Standard for Audit Opinions

By James Thomas, Arthur Luk, and Said Saba – June 30, 2016

The Second Circuit's recent decision in *In re Puda Coal Securities Inc. Litigation*, No. 15-2100 (2d Cir. May 20, 2016), clarified an important question regarding auditors' liability in applying *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318 (2015), the Supreme Court's decision limiting the circumstances in which a statement of opinion can be actionable under section 11 of the Securities Act of 1933. The first question courts applying *Omnicare* must confront is whether or not the statements at issue are statements of opinion or are statements of fact. In *Puda*, the Second Circuit summarily affirmed the district court's decision recognizing that auditors' reports are statements of opinion, not statements of fact that would subject auditors to liability under the Securities Act of 1933 or the Securities Exchange Act of 1934. Under *Omnicare*, such statements of opinion are actionable only if there is evidence the auditor provided an audit opinion it did not believe or that contains a misleading statement of fact or omits material facts.

Puda Coal Inc. was a coal company based in China and publicly traded in the United States. The company conducted its operations exclusively through Shanxi Puda Coal Group Co., 90 percent of which was indirectly owned by Puda. In 2009, Puda's chairman Ming Zhao, and his brother Yao Zhao, orchestrated the fraudulent transfer of Puda's entire interest in Shanxi to Ming Zhao personally, which left Puda without any revenue-generating assets. They further arranged for the transfer of 49 percent of the ownership of Shanxi to a state-owned private equity fund. Although the transfers were reflected in shareholder meeting minutes and reported to the Chinese government, Puda's financial statements for 2009 and 2010 continued to show that Puda maintained a 90 percent interest in Shanxi.

Puda's auditing firm, Moore Stephens Hong Kong, audited Puda's 2009 and 2010 financial statements, providing unqualified audit opinions. Moore Stephens and the investors in Puda did not discover the Zhao brothers' scheme until 2011 when a research report revealed the fraudulent transfers. Puda investors filed a securities class action claiming that, in providing unqualified audit reports on Puda's financial statements, Moore Stephens violated section 11 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934. Section 11 imposes liability for parts of a registration statement prepared by an expert, such as an auditor's report, but does not require scienter. Section 10(b) and the related Rule 10b-5 prohibit making an untrue statement of material fact or omitting a material fact necessary to

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make the statement not misleading in connection with the purchase or sale of a security. Unlike section 11, a plaintiff who brings a claim under section 10(b) must allege scienter.

In granting summary judgment to Moore Stephens, U.S. District Court Judge Katherine B. Forrest concluded that *Omnicare* applied to both a section 10(b) and section 11 claim, and that to be actionable the opinion statements in question must be both objectively and subjectively false; the statements must not only be false at the time they were made, the auditor must also not honestly believe the statements. According to the district court, “audit statements, such as the clean audit opinions presented by the Auditors in this case, are statements of opinion to which the subjective falsity requirement applies.” *In re Puda Coal Sec. Inc., Litig.*, 30 F. Supp. 3d 230, 259 (S.D.N.Y. 2014). Finding no evidence that Moore Stephens disbelieved its own audit opinions, the court had little trouble ruling against the plaintiffs. The Second Circuit agreed. The panel made clear that “[a]udit reports, labeled ‘opinions’ and involving considerable subjective judgment, are statements of opinion” and subject to the *Omnicare* standard.

*In re Puda Coal Securities Inc. Litigation* builds on *Omnicare* to provide attorneys representing auditors a clear tool with which to defend against section 10 or section 11 claims predicated on alleged false statements contained in audit reports. Conclusory allegations that an audit opinion turned out to be wrong are not sufficient. Absent sufficient factual allegations that reasonably call into question that an auditor knew the statements were false, disbelieved their own opinions, or omitted material facts, such claims are unlikely to survive scrutiny.

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