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Notwithstanding Janus…

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Law360, New York (December 09, 2011, 2:09 PM ET) -- In Janus Capital Group Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011), the United States Supreme Court defined what it means to "make" a statement under Securities and Exchange Rule 10b-5(b), holding that the maker of a statement is the person or entity with "ultimate authority" over the statement.[1]

Following Janus, some defendants have successfully argued that they were not the makers of allegedly false statements and have won dismissal of claims that they violated Rule 10b-5.[2] In Munoz v. China Expert Technology Inc., however, the Southern District of New York denied a Janus-based motion to dismiss brought by one member of an international accounting firm network (PKF New York) that participated in audits conducted by another member of the network (PKF Hong Kong). This article reviews the Supreme Court's holding in Janus and its first application in the context of auditor liability.

The Supreme Court's Holding in Janus Capital Group

In Janus, plaintiff shareholders alleged that a mutual fund investment adviser and administrator (Janus Capital Management LLC, a wholly-owned subsidiary of Janus Capital Group Inc.) should be held liable under Rule 10b-5(b) for statements made in the prospectuses of the managed fund (Janus Investment Fund). The district court dismissed claims against the investment adviser, but the Fourth Circuit Court of Appeals reversed, holding that the investment adviser made misleading statements by its "participation in the writing and dissemination of the prospectuses."[3]

In a 5-4 decision, the Supreme Court reversed the Fourth Circuit, holding that only those who make a statement — those with "ultimate authority" over the statement, not those who participate in the formulation of the statement — may be held liable under Rule 10b-5(b):

For purposes of Rule 10b–5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not "make" a statement in its own right. One who prepares or publishes a statement on behalf of another is not its maker. And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by — and only by — the party to whom it is attributed. This rule might best be exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit — or blame — for what is ultimately said.[4]

The court's ruling followed from its prior decisions that established Rule 10b-5 does not include a private aiding and abetting cause of action.[5] See, e.g., Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc., 128 S.Ct. 761 (2008). The court held in Stoneridge that companies that participated in deceptive transactions could not be held liable under Rule 10b-5, even when information about those transactions was incorporated into an issuer's false public statements, because those participants did nothing to dictate how the issuer disclosed the transactions.[6]

Following Stoneridge, Janus concluded that "the maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it. Without such authority, it is not necessary or inevitable that any falsehood will be contained in the statement."[7]

Notably, Janus rejected the argument that the well-known close relationship between a mutual fund and its investment adviser — the Janus fund and its adviser shared the same officers — required a different result.[8] The court refused this "invitation to disregard corporate form," concluding that while the investment adviser may have assisted the fund with crafting what the fund said in the prospectuses, the investment adviser did not itself make those statements for purposes of Rule 10b-5.[9]

Janus and the Liability of International Audit Firm Networks

Following the decision in Janus, PKF New York, a public accounting firm, moved to dismiss a claim that it was liable for allegedly false audit reports regarding China Expert Technology's financial statements.[10] PKF New York relied upon an admission from PKF Hong Kong — another member of PKF International Limited, a network of independently owned and operated accounting firms in around 125 countries[11] — that PKF Hong Kong issued the audit reports plaintiffs alleged were false. PKF New York therefore argued that under Janus, because it was a legally distinct entity from PKF Hong Kong, PKF New York was not the "maker" of the allegedly false statements[12]

Plaintiffs countered by arguing that PKF New York and PKF Hong Kong "jointly prepared and issued the false and misleading" audit opinions.[13] Plaintiffs' Fourth Amended Complaint alleged, for example, that PKF New York "reviewed and analyzed" how Generally Accepted Accounting Principles, Generally Accepted Auditing Standards, and SEC rules had to be implemented in the audits of China Expert Technology.

The complaint also alleged that both PKF New York and PKF Hong Kong conducted business using the name "PKF" or "PKF, Certified Public Accountants" and that the audit opinions were signed "PKF," without differentiating between PKF New York or PKF Hong Kong.[14]

The Southern District of New York (Hellerstein, J.) sided with plaintiffs. The district court concluded that Plaintiffs' allegations raised issues of fact regarding whether PKF New York exercised sufficient authority over what was said in the audit opinions to survive PKF New York's motion to dismiss, reasoning that:

[T]he PKF New York Engagement letter specifically stated that PKF New York would "review the entire filings with the SEC for compliance." Furthermore, according to the complaint, PKF New York's Managing Director gave final approval of the opinions before they were signed, and then the audit documents were simply signed "PKF" with no indication as to which corporate entity issued them. These allegations, and others, create genuine issues of fact as to whether PKF New York explicitly or implicitly controlled sufficient — and thus 'made' — the statements in question.[15]

Conclusion

The bright-line rule established by Janus should limit the potential liability under Rule 10b-5(b) of members of international accounting firm networks: under Janus, a member firm that issues an audit report has ultimate authority over, and is the "maker" of, the audit report, while other member firms that merely assist in the conduct of the audit should not be deemed makers of the audit report.

Yet Munoz, like other cases concerning the potential vicarious liability of members of international audit firms for other members, reinforces the importance that member firms should observe corporate formalities — by, for example, attributing audit opinions issued by one member firm specifically to that member firm (e.g., PKF Hong Kong, rather than simply PKF)[16] — if the limitation of liability will apply.

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John Massaro was counsel to Motorola Inc. in the Stoneridge case discussed in this article.

[1] As the court explained in Janus, Rule 10b–5 makes it "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, ... [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading ... ." 131 S.Ct. 2296 at 2301, n. 4 (quoting 17 CFR § 240.10b–5(b)).

[2] See, e.g., In re Coinstar Inc. Sec. Litig., C11-133 MJP, (W.D. Wash. Oct. 6, 2011); SEC v. Kelly, No. 08 Civ. 4612, --- F.Supp.2d ---, (S.D.N.Y. Sept. 22, 2011).

[3] 131 S.Ct. at 2301 (quoting In re Mutual Funds Inv. Litigation, 566 F.3d 111, 121 (4th Cir. 2009).

[4] 131 S. Ct. 2296 at 2302.

[5] Id.

[6] Id. at 2303.

[7] Id. (internal quotations omitted).

[8] Id. at 2304.

[9] Id. at 2305.

[10] See, e.g., PKF New York's Memorandum of Law in Support of Motion to Dismiss the Complaint as against Defendant PKF New York, Munoz v. China Expert Technology, Inc., No. 07-CV-10531 (S.D.N.Y.) (Dkt. 171, Aug. 26, 2011). Shortly after Janus was decided, the district court granted PKF New York's motion for reconsideration of a prior order denying its motion to dismiss. See Endorsed Memorandum of Law in Support of PKF New York's Motion for Reconsideration, Munoz v. China Expert Technology Inc., No. 07-CV-10531 (S.D.N.Y.) (Dkt. 166, Aug. 26, 2011).

[11] Id. at 2, n.4.

[12] Id.

[13] See generally Fourth Amended Complaint at ¶ 215, Munoz v. China Expert Technology Inc., No. 07-CV-10531 (S.D.N.Y.) (Dkt. 151, Apr. 4, 2011).

[14] See id. at ¶¶ 216-224.

[15]Order Denying Defendant PKF New York's Motion to Dismiss the Fourth Amended Complaint, Munoz v. China Expert Technology, Inc., No. 07-CV-10531 (S.D.N.Y.) (Dkt. 183, Nov. 7, 2011).

[16] Compare, e.g., Cromer Fin. Ltd. v. Berger, 00 CIV. 2284 (DLC), 2002 WL 826847, at *3 (S.D.N.Y. May 2, 2002) (finding allegations of agency between an international coordinating firm and its Bermudan member firm sufficient to withstand a motion to dismiss) with Star Energy Corp. v. RSM Top-Audit, No. 08 Civ. 00329, 2008 WL 5119019 (S.D.N.Y. Nov. 26, 2008) (dismissing claims against the international coordinating firm because plaintiffs failed to allege it exercised control over the audits performed by its Russian member firm).