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THE IMPACT OF *OMNICARE* ON AUDITOR LIABILITY UNDER THE FEDERAL SECURITIES LAWS

The Supreme Court's Omnicare *decision, holding that statements of opinion are actionable under Section 11 of the Securities Act of 1933 only in limited circumstances has important implications for auditors' liability for their audit opinions. The author discusses the case and reviews subsequent lower court decisions extending Omnicare to Section 10(b) and Section 18 of the Exchange Act.*

By Sarah L. Cave *

As lower courts apply the Supreme Court's holding in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*,[1] the developing jurisprudence confirms that the decision has profound implications for cases against auditors and that its reasoning applies not only to claims under Section 11 of the Securities Act of 1933,[2] as in *Omnicare* itself, but also to claims against auditors under Section 10(b) and Section 18 of the Securities and Exchange Act of 1934.[3]

In *Omnicare*, the Supreme Court addressed strict liability under Section 11 for misrepresentations or material omissions in registration statements, ruling that statements of opinion are actionable only in three limited circumstances: (1) the speaker subjectively believes the opinion to be untrue, (2) the opinion statement contains embedded statements of fact that are misleading, or (3) the opinion "omits material facts about the issuer's inquiry into or knowledge" about the statement, and those facts "conflict with what a reasonable investor would take from the statement itself."[4] On the other hand, a genuinely held opinion, regardless of whether it is proven wrong, cannot be a misstatement giving rise to Section 11 liability.[5]

Although *Omnicare* did not directly address claims against auditors, the profession immediately began to consider how the decision would apply to the "opinions" auditors provide regarding financial statements they have audited.

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1. 135 S. Ct. 1318 (2015).

2. 15 U.S.C. § 77.

3. 15 U.S.C. §§ 78a, 78r.

4 *Omnicare*, 135 S. Ct. at 1325-27, 1329.

5. *Id.* at 1327.

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The Extension of Omnicare

While *Omnicare* explicitly concerned only Section 11 liability, the Section 11 language at issue — that a party is liable for "an untrue statement of material fact or omitted to state a material fact . . . necessary to make the statements therein not misleading" — is either identical or closely analogous to language in other federal securities laws, including Sections 10(b) and 18, statutes whose scopes are broader than Section 11, which is focused on registration statements. Perhaps unsurprisingly, then, district courts across the country began expanding — occasionally even without explicit analysis — *Omnicare*'s reach to these other, similarly phrased federal securities laws.[6]

Even decisions that declined to find *Omnicare* controlling in cases involving statutes other than Section 11 nonetheless applied its reasoning and analysis.[7]

The Tenth Circuit was the first circuit court to expand the application of *Omnicare* to Section 10(b) claims. In *Nakkhumpun v. Taylor*, the plaintiffs challenged a statement made by the company's president during a conference call to discuss quarterly financial results in which he said that the company was in a "far better financial situation" than the year prior.[8] The Tenth Circuit confirmed that *Omnicare* applied to plaintiffs' Section 10(b) claim and ruled that the facts allegedly known by the defendants — that the company was in poor financial health when the statement was made — were insufficient to "cast doubt on the sincerity or reasonableness of [the company president's] statement of his opinion."[9]

In its first opinion applying *Omnicare*, the Second Circuit also expressly affirmed the application of *Omnicare* to Section 10(b) claims. In *Tongue v. Sanofi*, the plaintiffs, holders of certain contingent value rights ("CVR"), asserted Section 10(b) claims against a pharmaceutical company, its predecessor, and three executives after the FDA did not approve the defendants' drug (Lemtrada) before the date entitling the CVR holders to cash payouts.[10] Examining the allegedly misleading opinions that the defendants made in the offering materials, the court applied *Omnicare* and emphasized the "need to examine the context" of the allegedly misleading opinion, including the sophistication of the plaintiffs. After rejecting the plaintiffs' suggestion that *Omnicare* required the defendants to disclose FDA feedback arguably undermining the defendants' optimistic projections, the court held instead that *Omnicare* did not require that all information conflicting with an opinion be disclosed, even if investors might have acted differently had they known that information and affirmed dismissal of the complaint.

Application of Omnicare *to Auditors*

As *Omnicare*'s reach has expanded beyond Section 11, auditors have sought, with mixed success,

6. *See, e.g.*, *In re Amarin Corp. PLC*, No. 13-cv-06663, 2015 WL 3954190, at *7 n. 14 (D.N.J. June 29, 2015) (assuming that Omnicare's opinion statement analysis applied to the Section 10(b) claims at issue); *Corban v. Sarepta Therapeutics, Inc.*, No. 14-CV-10201-IT, 2015 WL 1505693, at *11 (D. Mass. Mar. 31, 2015) (applying *Omnicare* analysis to Section 10(b) claims); *In re Genworth Fin. Inc. Sec. Litig.*, 103 F. Supp. 3d 759, 766 (E.D. Va. 2015) ("*Omnicare*'s holding is applicable and relevant to the instant case as the standard defined in Section 11 of the Securities Act is nearly identical to the [Section 10(b)] standard at issue here.").

7. *In re Merck & Co., Inc. Sec., Derivative & ERISA Litig.*, No. 05-cv-01151, 2015 WL 2250472, at *11 n. 7 (D.N.J. May 13, 2015) (noting that while "*Omnicare*, actually, is not directly applicable" to Section 10(b) claims, "*Omnicare*'s analysis of its discussion of misleading opinions is . . . instructive on the viability of [those] claims as to the opinion-based" statements); *Firefighters Pension & Relief Fund of the City of New Orleans v. Bulmahn*, No. 13-3935, 2015 WL 7454598, at *25-26 (E.D. La. Nov. 23, 2015) (stating that "[i]t is not clear . . . that the Supreme Court's analysis in *Omnicare* extends to securities fraud claims under Section 10(b) of the Securities Act of 1934" but "[i]n the case of non-forward-looking opinion statements, the Court will use *Omnicare* as guidance").

8 782 F.3d 1142 (10th Cir.), *cert. dismissed*, 136 S. Ct. 499 (2015).

9. *Id.* at 1159-60.

10. 816 F.3d 199 (2d Cir. 2016).

to apply the limits imposed by *Omnicare* on liability for audit opinions. One of the first examples is *In re Velti PLC Securities Litigation*, in which a district court for the Northern District of California dismissed a Section 10(b) claim concerning allegations that auditor Baker Tilly's opinions were false and omitted information about Velti's difficulty in collecting certain receivables.[11] The court noted that "several courts to consider such statements [of opinion] under Section 10(b) since *Omnicare* have applied the *Omnicare* analysis," and held that the pleading was insufficient as a matter of law because it failed to allege either that the auditor did not believe the bad debt reserves were inaccurate or that the auditor omitted specific facts that rendered the audit opinions misleading. The plaintiffs appealed the decision, but the parties reached a settlement in April 2016.

In two summary orders, the Second Circuit applied *Omnicare* in dismissing claims against auditors. First, in *Special Situations Fund III QP, L.P. v. Deloitte Touche Tohmatsu CPA, Ltd.*, the court applied *Omnicare* in upholding dismissal of a Section 18 claim against ChinaCast's auditor, Deloitte's Hong Kong member firm.[12] Plaintiffs were investors in ChinaCast, whose executives had perpetrated a years-long fraud. Plaintiffs alleged that Deloitte Hong Kong committed securities fraud when it issued "clean" audit opinions despite purportedly being aware of certain "red flags." In affirming dismissal, the Second Circuit found that plaintiffs failed to allege that the auditor's opinions constituted false or misleading statements, such as by alleging that the auditor did not honestly hold its opinions or that the auditor omitted material facts on which the opinions were based, allegations that were necessary in light of *Omnicare*.[13]

The Second Circuit again applied *Omnicare* in its summary order in *Querub v. Moore Stephens Hong Kong*, affirming summary judgment for auditor Moore Stephens Hong Kong.[14] The plaintiff investors had alleged that the auditor overlooked a fraud committed by a Puda Coal executive. The Second Circuit ruled that, although the auditor had issued unqualified opinions on financial statements that failed to note the sale of the Chinese company's sole assets, the investors did not present sufficient evidence for their Section 11 claim because they failed to show that Moore Stephens either did not believe its opinions or that its audit reports omitted material facts about the basis of its opinions.[15]

Other courts have sustained claims against auditors in the face of *Omnicare* challenges. In *In re Lehman Brothers Securities & ERISA Litigation*, the court denied Ernst & Young's motion for summary judgment on a claim concerning its audits of the defunct investment bank Lehman Brothers.[16] The court found that plaintiffs presented evidence sufficient to raise a genuine issue of material fact as to six "red flags" which, when taken as a whole, "could permit the inference that the auditor did not actually believe that it had conducted a GAAS-compliant audit . . . when it rendered its opinions."[17] One of the "red flags" that the court found "compelling" was that Ernst & Young reviewed certain reports containing "spike graphs" that suggested "Lehman's quarter- and year-end balance sheets were misleading as to its net leverage ratio by virtue of its use of [certain repurchase agreements] . . . The issue over the timing and content of [a meeting between Lehman and Ernst & Young officials] likewise present[ed] a *bona fide* factual dispute which, if resolved in plaintiffs' favor," could support the conclusion that Ernst & Young was aware that Lehman was engaging in "window dressing" on its balance sheet.[18]

In *In re Petrobras Securities Litigation*, the district court granted PricewaterhouseCoopers' motion to dismiss Section 10(b) claims, but declined to dismiss Section 11 claims concerning PwC's audits of the Brazilian state-owned oil company Petróleo Brasileiro ("Petrobras").[19] The plaintiffs claimed that PwC failed to detect red flags concerning Petrobras' involvement "at the center of a multi-year, multi-billion dollar bribery and kickback scheme." Although the plaintiffs' Section 10(b) claim was dismissed for failing to plead scienter adequately, the court found that the complaint satisfied *Omnicare* as to the Section 11 claim by sufficiently alleging that PwC's audit opinions embedded actionable statements of fact in the form of the financial statements on which PwC opined. The

[11] 13-CV-03889-WHO, 2015 WL 5736589, at *35 (N.D. Cal. Oct. 1, 2015).

[12] No. 15-1813, 645 F. App'x 72, 2016 WL 1392280 (2d Cir. Apr. 8, 2016), *cert denied* 137 S. Ct. 186 (2016).

[13] *Id.* at *3.

[14] No. 15-2100, 649 F. App'x 55, 2016 WL 2942415 (2d Cir. May 20, 2016).

[15] *Id.* at *3.

[16] 131 F. Supp. 3d 241, 259 (S.D.N.Y. 2015).

[17] *Id.*

[18] *Id.* at 256.

[19] No. 14-cv-9662 (JSR), 2016 WL 1533553 (S.D.N.Y. Feb. 19, 2016).

court reasoned that whether a fact is "embedded" may be determined by whether the value of the opinion statements is affected if the facts in question were removed. The court explained that investors' expectation that audit opinions are based on facts stated in the financial statements forms the basis of the value of an auditor's opinion, and therefore the facts in the financial statements themselves should be considered embedded in the audits. Alternatively, even if the financial statements were not facts embedded in the audit opinions, *omitting* those facts when a reasonable investor would assume that the audit reports were based on the facts within the financial statements was another potential basis for liability. The court also rejected PwC's assertion that *Omnicare* did not extend liability to the financial statements, which consisted of estimates and assumptions, holding that treating the financial statements as opinions would counteract the aim of imposing Section 11 liability on auditors for the portion of financial statements that they certify. The court noted that "[a]n additional inference to be drawn from these allegations is that the supporting evidence PwC relied on when forming its opinion was insufficient or untrue."[20]

In *Johnson v. CBD Energy Ltd.*, however, a district court in the Southern District of Texas disagreed with the *Petrobras* court's interpretation of *Omnicare*.[21] *Johnson* was a purported class action brought by investors of the Australian company CBD Energy Limited ("CBD") (now known as BlueNRGY Group Limited), whose offering documents failed to disclose self-dealing transactions by one of its directors. The plaintiffs asserted Section 11 claims against the Australian PwC firm, whose audit opinions on CBD's financial statements were included in CBD's registration statement. The Texas court rejected the investors' argument that, because the truth of an audit report is based on the underlying facts of financial statements, there is an "auditor" exception to the application of *Omnicare*. The court noted that *Omnicare* outlined three exceptions to its "pure statement of opinion" rule, and did not mention an additional exception for auditor certifications.[22]

Addressing the investors' argument that the audit opinions, like those in *Petrobras*, were based on "embedded statements of facts" contained in the CBD financial statements, the court concluded that the *Petrobras* court misunderstood *Omnicare*'s idea of "embedded statement of facts" because the audit opinions in dispute were not based on an "underlying, verifiable fact" that appears in the audit report itself. "The numbers in CBD's financial statements," the court explained, "are not 'embedded' in a subordinate clause in any of PwC Australia's sentences in the way the *Omnicare* Court set out."[23] Holding that the plaintiffs' allegations failed to satisfy *Omnicare*, the court dismissed the Section 11 claims with prejudice.

CONCLUSION

As the Supreme Court's analysis in *Omnicare* has worked its way through the lower courts, the decision has appeared less like a magic bullet and more like an additional tool in the toolbox that, in the right circumstances, may be used as part of a successful defense against Section 11, Section 10(b), and Section 18 claims against auditors. ■

[20] *Id.* at *4.

[21] No. 4:15-cv-01668, 2016 WL 3654657 (S.D. Tex. July 6, 2016).

[22] *Id*. at *10.

[23] *Id.* at *12.