

### **Second Circuit and Seventh Circuit Affirm Dismissals of § 10(b) and Other Claims Against Independent Auditors**

*Decisions establish limited liability of auditors (a) to third-party investors in client, (b) for alleged failure to disclose client's fraud, absent evidence of scienter, (c) for alleged failure to correct client's statements in reviewed but unaudited quarterly financial statements, and (d) for alleged statements not concealing the risk that caused plaintiffs' loss.*

In recent years, independent auditors and accountants increasingly have been the target of securities, negligence, and other claims in the wake of some companies' restatements, bankruptcies, and other accounting and financial problems. Two recent federal appellate decisions make clear the hurdles plaintiffs face in asserting such claims against independent auditors.

In *Tricontinental Industries v. PriceWaterhouseCoopers, LLP*, No. 05-4322 (7<sup>th</sup> Cir. Jan. 17, 2007), the Seventh Circuit affirmed the district court's dismissal of § 10(b), common law fraud, and negligent misrepresentation claims against PwC on several grounds. The Seventh Circuit affirmed the dismissal of the plaintiffs' negligent misrepresentation claim, holding that under Illinois law, an accountant's services performed for the benefit of its client establish that the primary intent of the client was not to benefit or influence the third-party plaintiff and that the accountant thus had no duty to the third-party plaintiff, even accepting as true the plaintiff's allegation that the accountant knew that the plaintiff was relying on the audited financial statements in deciding to invest in the client. The Seventh Circuit also affirmed the dismissal of the plaintiffs' common law fraud and securities fraud claims, holding that pleading an accountant's alleged interest in fees and in maintaining a good relationship with the client is insufficient to establish scienter, even accepting as true the plaintiff's allegation that the accountant knew of but did not disclose the client's fraud. The Seventh Circuit also held that the plaintiffs did not adequately plead loss causation, because it could not reasonably be inferred that the plaintiffs' losses were caused by any alleged misstatement by PwC in audits that predated the company's financial statements about which the

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company later disclosed accounting irregularities. The full text of the opinion is available at [www.ca7.uscourts.gov](http://www.ca7.uscourts.gov) (under "Opinions").

In *Lattanzio v. Deloitte & Touche LLP*, No. 05-5805-cv (2<sup>nd</sup> Cir. Jan. 31, 2007), the Second Circuit affirmed the district court's dismissal of § 10(b) and breach of fiduciary duty claims against Deloitte. The court held that federal securities regulations requiring Deloitte, the company's independent auditor, to review the company's quarterly financial statements did not create any duty on Deloitte's part under § 10(b) to correct those unaudited financial statements, nor did the regulations or Deloitte's review associate Deloitte with the statements to such a degree that they became Deloitte's statements. The Second Circuit also held that when an auditor's alleged duty to correct errors in a client's financial statements first arises before the plaintiffs' claimed class period, the claims are barred. Finally, the court held that the plaintiffs did not adequately plead loss causation, because (a) the "relevant risk" allegedly concealed by the auditor must be the risk of the client's bankruptcy or other financial or accounting problems that caused the plaintiffs' loss, not the risk that the audits were not performed in accordance with Generally Accepted Auditing Standards (GAAS) or Generally Accepted Accounting Principles (GAAP), and (b) in this case, the auditor had issued a "going concern" warning thus making the risk of bankruptcy apparent, and the client's alleged misstatements were far more numerous and egregious than the auditor's alleged misstatements. Retired Supreme Court Justice Sandra Day O'Connor, sitting by designation, joined the panel's unanimous decision. The full text of the opinion is available at [www.ca2.uscourts.gov](http://www.ca2.uscourts.gov) (under "Decisions").

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