No. 24-1151

IN THE

# Supreme Court of the United States

BDO USA, LLP,

*Petitioner*,

v.

NEW ENGLAND CARPENTERS GUARANTEED ANNUITY AND PENSION FUNDS, ET AL.,

*Respondents*.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

## BRIEF IN OPPOSITION


Samuel H Rudman
David A. Rosenfeld
Robert D. Gerson
Mark T. Millkey
ROBBINS GELLER RUDMAN & DOWD LLP
58 S. Service Rd.
Suite 200
Melville, NY 11747

Kevin K. Russell
*Counsel of Record*
RUSSELL & WOOFTER LLC
1701 Pennsylvania Ave. NW
Suite 200
Washington, DC 20006
(202) 240-8433
*kr@russellwoofter.com*

Andrew Love
ROBBINS GELLER RUDMAN & DOWD LLP
Post Montgomery Ctr.
One Montgomery Street,
Suite 1800
San Francisco, CA 94104

## QUESTIONS PRESENTED

1. Whether the court of appeals adopted a categorical rule for determining the materiality of an auditor's false claim that it conducted an audit in accordance with professional auditing standards.

2. Whether the Court should adopt petitioner's proposed categorical rule regarding the materiality of one kind of statement by one particular kind of entity in securities fraud cases when no court has adopted that rule and it wouldn't make a difference to the outcome of this case in any event.

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## BRIEF IN OPPOSITION

The petition asks this Court to resolve a supposed 1-1 circuit conflict over when an auditor's false claim that it conducted an audit in accordance with professional auditing standards is material to investors. Pet. i. Petitioner claims that the Sixth Circuit has adopted the categorical rule that "an auditor's false statement of compliance with professional auditing standards is material only if the noncompliance creates 'a substantial risk that the actual value of assets or profits were significantly less than what the company's financial statements indicated.'" Pet. 1 (quoting *Adams* v. *Standard Knitting Mills, Inc.*, 623 F.2d 422, 432 (6th Cir. 1980)).[1] And it accuses the Second Circuit of adopting the opposite categorical rule—that such statements are always material. *Id*. at 2. Because the petition is premised on a misdescription of the law of both circuits, and because the Second Circuit's actual holding does not warrant review, the petition should be denied.

Petitioner cannot even convince its own amici that the Second Circuit adopted a categorical rule. *See* Br.

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[1] Before 2004, the certification language included in audit opinions required, among other things, a statement of compliance with Generally Accepted Auditing Standards ("GAAS"). After 2004, the required language was changed to require a statement that the auditor had conducted its audit in accordance with the standards promulgated by the Public Company Accounting Oversight Board ("PCAOB"). PCAOB Release No. 2003-025. Cases cited in this brief where the audits pre-date 2004, such as *Adams*, refer to compliance with GAAS; the audit opinion at issue in this case, which is from the audit of AmTrust Financial Services, Inc.'s ("AmTrust") 's 2013 financial results, refers to compliance with PCAOB standards.

American Institute of Certified Public Accountants 9 ("Although the Second Circuit's conclusion *was specific to that case and that audit*, it *could be misinterpreted* to establish a new rule that any alleged noncompliance with the Auditing Standards is always material to investors.") (emphasis added). In fact, the court of appeals held only that, on the facts of this case, petitioner had failed to show that its statements were so clearly immaterial as to support dismissal on the pleadings.

Nor has the Sixth Circuit adopted the categorical rule petitioner attributes to it. The only case petitioner cites simply applied settled materiality precedent to the particular theory of liability asserted in that case. Indeed, in the nearly half-century since *Adams* was decided, no court has cited the case's materiality holding, much less read it as creating the categorical rule petitioner claims.

There is no reason for the Court to rush to decide petitioner's Question Presented in the absence of a clear conflict. Petitioner does not claim that audit standards certifications give rise to materiality disputes any more recurringly than the countless other kinds of statements that form the basis for securities fraud claims. And its dire predictions of what will happen to the audit industry if the Second Circuit's decision stands is based entirely on its mischaracterization of what the court of appeals held. If that were not enough, this case is a poor vehicle for considering whether to adopt petitioner's categorical rule because petitioner would lose even under the rule it proposes.

## STATEMENT OF THE CASE

### I. Factual Background

In 2017, AmTrust, one of the nation's largest insurers, admitted that its past five years of financial statements substantially overstated the company's revenues. Pet. App. 3a. Among other things, it acknowledged that despite specific warnings from the Securities and Exchange Commission ("SEC" or "Commission"), and in violation of generally accepted accounting principles ("GAAP"), it had prematurely recognized revenue it expected to receive over the multi-year course of certain extended warranty contracts. *Id*. 4a (noting this was one of two GAAP errors the firm admitted were material).

It is precisely to avoid such errors that federal securities laws require that a company's public financial statements be audited in compliance with standards established by the Public Company Accounting Oversight Board ("PCAOB"). *See* 15 U.S.C. §§ 78m(a)(2), 78j-1, 7262(b); 17 C.F.R. §§ 210.1-01, 210.2-02. In this case, those audits were conducted by petitioner BDO for four of the five restated years. Pet. App. 9a. This case concerns BDO's 2013 audit. *Id*. 34a. For that year, despite the significant deviations from GAAP, and resulting substantial overstatement of income, BDO issued an "unqualified opinion" that the financial statements "present fairly, in all material respects the financial position of AmTrust Financial Services, Inc." *Id*. 97a. BDO further certified that its opinion was based on an audit conducted "in accordance with the standards of the Public Company Accounting Oversight Board." *Ibid*. And it stated that it "believe[d] that our audits provide a reasonable basis for our opinion." *Ibid*.

In April 2017, *The Wall Street Journal* reported that state and federal officials had opened investigations into BDO's audits. Pet. App. 37a. According to the article, a former BDO auditor-turned-whistleblower revealed that BDO had issued its 2013 audit opinion before having completed the audit, failing to conduct important aspects of the work before publicly representing that AmTrust's financial statements fairly stated its position. *Ibid*. By the time this news broke, the market had already downgraded AmTrust's stock price to reflect the Company's earlier announcement that its financial statements for 2013 (and other years) required restatement. In response to the additional news drawing into question the overall integrity of the 2013 audit, AmTrust's stock fell an additional 18.9%. *Ibid*; C.A.J.A. 74 (Complaint ¶ 98).

The SEC completed its investigation in October 2018, and, in an order "Making Findings and Imposing Remedial Sanctions," confirmed that BDO auditors had certified the financial statements despite not actually completing the audit. Pet. App. 34a.[2] The SEC Order detailed the Commission's factual findings of egregious and repeated improper professional conduct, including "intentional or knowing conduct" (SEC Order ¶ 70), pertaining to the issuance of the 2013 Opinion. The Order described a pervasive failure

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[2] *See* Order Instituting Public Administrative Proceedings Pursuant to Section 4C of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 102(e) of the Commission's Rules of Practice, Making Findings and Imposing Remedial Sanctions in In the Matter of Richard J. Bertuglia, CPA, John W. Green, CPA, and Lev Nagdimov, CPA, Admin. Proceeding File No. 3-18868 (U.S.S.E.C. Oct. 12, 2018) ("SEC Order").

to undertake required audit procedures and collect sufficient audit evidence—constituting violations of PCAOB standards (*id.* ¶¶ 5-6, 40-67)—as well as acts of concealment to obscure those failures. *Id.* ¶ 3. This misconduct included, *inter alia*, improperly pre-dating audit documentation by signing blank or incomplete work papers and audit programs (*id*. ¶¶ 21-22), failing to review thousands of work papers before authorizing the issuance of the 2013 Opinion (*id*. ¶¶ 23-25), signing work papers without reviewing them (*ibid*.), and concealing this misconduct until the issuance of the SEC Order (*id*. ¶ 30). As a result of these "significant audit deficiencies," *id*. ¶¶ 4, 31, the SEC found that the "audit team did not have sufficient audit evidence to support BDO's audit report when it was included in AmTrust's Form 10-K on March 3, 2014." *Id*. ¶ 31.

The SEC noted that two of the BDO supervisors involved claimed that the audit work was subsequently completed and that they had "reviewed the completed audit work and concluded that the omitted procedures did not affect BDO's previously issued audit report." *Id*. ¶ 30. But the SEC did not accept those representations. "In fact," the Commission found, "there is no documentation of *any* assessment of omitted procedures," and "neither Bertuglia nor Green documented their own assessment or review." *Ibid* (emphasis in original). The SEC then suspended Bertuglia, Green, and one other auditor for three years. *Id*. § IV.

## II. Procedural History

1. Respondents filed this proposed investor class action against AmTrust, certain AmTrust executives, the underwriters of two AmTrust-issued securities

offerings, and BDO. As relevant here, respondents asserted that BDO violated Section 10(b) of the Exchange Act and Rule 10b-5 of its implementing regulations by falsely certifying that its 2013 unqualified audit opinion had been conducted in accordance with PCAOB standards. Pet. App. 33a.[3]

The district court dismissed. Although it found that the Complaint plausibly alleged that BDO's certification was knowingly false, the court held that the falsehood was immaterial to investors. Pet. App. 155a-56a.

2. The Second Circuit initially affirmed. It agreed with the district court that "the Complaint fails to allege any link between BDO's misstatements in the 2013 Audit Opinion and the material errors contained in AmTrust's 2013 Form 10-K." *Id.* 75a. And it held that the certification language on its own was "so general" that reasonable investors would not rely on it. *Id.* 75a-76a (quoting *ECA & Loc. 134 IBEW Joint Pension Tr. of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 206 (2d Cir. 2009)). The panel made clear, however, that it was not establishing any general rule. *Id*. 76a. "Rather, *in this case*, as the District Court held, Appellants have failed 'to allege any facts relevant to the way or ways in which BDO's failure[s] . . . would have been significant to a reasonable investor in making investment decisions." *Ibid*.

3. Respondents filed a petition for panel rehearing, raising three issues as to BDO. First, they argued the panel erred in finding that the Complaint failed to allege a link between the false certification

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[3] Respondents' claims against AmTrust, and certain dismissed claims against BDO, are not at issue before this Court.

and AmTrust's financial results. Resp. Reh. Pet. 12-16. Second, respondents argued that no such link was required to establish materiality in any event. *Id*. 10-11, 13-14. Third, respondents challenged the panel's determination that a certification of compliance with PCAOB standards is "too general" to be material. *Id*. at 16-19. On the last two points, respondents were supported by an amicus brief on behalf of former SEC officials. *See* Brief of Former SEC Officials as Amici Curiae in Support of Petition for Panel Rehearing, Doc. 187. The panel subsequently invited the SEC to submit a brief "expressing its views on the arguments amici raise." Doc. 191. The SEC accepted the invitation and urged the panel to grant rehearing. *See* SEC C.A. Br. 2.

The Commission's brief explained that public acceptance of the accuracy of financial statements depends on investors' confidence in auditors faithfully performing their role. *Id*. 9-10. For that reason, certifications of compliance with auditing standards "convey crucial information to the investing public," even though the certification itself may be briefly stated, using standardized language required by regulation. *Id*. 2-3. If the audit "was not conducted in accordance with PCAOB standards," the SEC explained, "the auditor cannot issue an unqualified opinion." *Id*. 5. And that "outcome has significant consequences." *Ibid*. It may preclude registration and public sale of the firm's securities and "will be immediately noted by investors and markets, who price the attendant consequences and risks." *Ibid*. "Investors thus rely on the auditor's certification . . . in making investment decisions, as courts and the Commission have found." *Id*. 9 (collecting authorities).

This is true, the Commission emphasized, even if audit failures cannot be linked to errors in an audited financial statement. "A false certification concealing a deficient audit has independent significance: it eliminates the basis for investors' reliance on the auditor and subjects investors to increased (and hidden) risk." *Id*. 13. For that reason, the Commission has long viewed itself as empowered to sanction auditors under Section 10(b) for false certification statements without regard to the effect on financial statements, something it could not do under the panel's (original) materiality standard. *See id*. 10-11 (collecting examples). "To the extent the Court sought to ensure that false audit certifications be tethered to plaintiffs' harm," the Commission advised, "other elements that Congress and the courts have imposed on the implied private right of action may provide recourse." *Id*. 14 (giving examples of reliance and loss causation).

4. The Second Circuit granted the petition for rehearing and issued a revised opinion. *See* Pet. App. 1a. The court stressed that the question at the pleading stage is not whether the misstatements were immaterial, but whether "they are so *obviously* unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." Pet. App. 35a-36a (emphasis added, citation omitted). Petitioner failed to meet that standard, the court held, because the certification was not, on further consideration, "too general" to be relied upon. Pet. App. 36. Instead, the "absence of BDO's certification would have been significant, for without it, BDO could not have issued an unqualified opinion, AU508.07, which then would have alerted investors to potential problems in the company's financial reports."

*Ibid*. "The false certification thus subjected unknowing investors to the risk that AmTrust's financial statements were unreliable." *Ibid*.

The panel notably did not repeat its prior statement that the Complaint failed to allege a link between the audit failures and the errors in the financial statements. *Compare* Pet. App. 75a (original opinion) *with id*. 36a (revised opinion). Instead, the court held that because the standard language required to be included in unqualified audit opinions can have independent significance to investors, respondents "were not required to allege a link between BDO's false certification and specific errors in AmTrust's financial statements to establish that BDO's false audit certification was material." *Ibid*.

The Court then reversed the district court's finding that investors had failed to allege loss causation. *Id*. 36a-38a. It explained that BDO's false certification had maintained an artificial inflation in AmTrust's stock price, which would have been lower at the time plaintiffs purchased shares if BDO had told the truth. *Id*. 38a. This was aptly demonstrated, the court found, by the drop in AmTrust's stock price after *The Wall Street Journal* disclosed the falsity of the certification, *id*. 37a, weeks after a prior price decline in response to news that the financial statements required restatement.[4]

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[4] As in its initial opinion, the Second Circuit also reinstated respondents' Section 11 claims against AmTrust, its executives, and the underwriters of the relevant securities offerings, holding that the upfront recognition of warranty revenue constituted a material misrepresentation of the firm's revenue. *See* Pet. App. 17a-21a.

## REASONS FOR DENYING THE PETITION

Petitioner claims that the Second Circuit departed from this Court's materiality precedents and created a circuit conflict by holding that false statements of GAAS compliance are per se material. That is incorrect. The court of appeals created no categorical rule, and its actual holding does not conflict with the decisions of this Court or any other circuit. The Question Presented moreover is not recurring or important, as it merely addresses the application of settled materiality law to one of the virtually limitless kinds of statements that can give rise to securities claims. And even if the question warranted review, this case provides a poor vehicle for deciding it, as petitioner would lose even under the rule it proposes. The petition should be denied.

### I. The Second Circuit Did Not Create Any Categorical Rule In Conflict With This Court's Materiality Precedents.

1. Petitioner does not deny that the court of appeals stated the correct materiality standard, quoting this Court's holding in *Basic Inc. v. Levinson* that, at "the pleading stage, a plaintiff satisfies the materiality requirement . . . by alleging a statement or omission that a reasonable investor would have considered significant in making investment decisions." Pet. App. 35a (quoting 485 U.S. 224, 231-32 (1988)). Petitioner nonetheless contends that the Second Circuit "defie[d] this Court's materiality precedents" by adopting a "*per se* materiality standard" for audit certifications. Pet. 26. That objection is wrong because the premise is false—the court of appeals did not adopt any categorical rule.

Because the appeal arose on a motion to dismiss, the Second Circuit disavowed deciding whether the particular statements before it were material or not. Instead, given the posture, the question before it was whether petitioner's misstatement was "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." Pet. App. 35a-36a (citation omitted). The Second Circuit then applied that test to the facts of the specific case before it. *See id.* 36a ("With these basic principles in mind, we conclude that the Appellants adequately alleged that the misstatements in BDO's 2013 Audit Opinion were material."). In its initial opinion, the panel expressly disavowed creating any categorical rule, holding open that a false certification might be material in a different case. Pet. App. 76a. Having concluded on rehearing that the statements in this case were adequately alleged to be material, the court had no occasion to repeat the caveat about future cases. But nothing in the revised opinion reflects the panel's decision to do an about-face and establish a per se rule.

To be sure, the Court rejected *petitioner's* proposed categorical rule, holding that "Appellants were not required to allege a link between BDO's false certification and specific errors in AmTrust's financial statements to establish that BDO's false audit certification was material." *Id*. 36a. But in holding that the "Appellants" in this case were not required to make that showing, it did not adopt a categorical rule for all future parties and cases. Instead, the court held that petitioner failed to show that "reasonable minds could not differ on the question of [the] importance" of its misstatements because a reasonable jury could find that the audit failures in this case were so significant

as to cause reasonable investors to suspect "potential problems with the company's financial reports." *Ibid*.

Critically, in so holding, the court of appeals did not declare that a minor deviation from auditing standards renders a certification materially false, a rule that petitioner says would have catastrophic consequences for auditors given the number and complexity of audit rules. *See* Pet. 20-21. That question did not arise in this case because the audit failures were anything but minor. As the SEC investigation found, because the omitted steps were not performed, the "audit team did not have sufficient audit evidence to support BDO's audit report" attesting to the fairness and accuracy of AmTrust's admittedly inaccurate financial statements. SEC Order ¶ 31.

Notably, petitioner cannot persuade even its own amici that the decision establishes a per se rule. The Brief of the American Institute of Certified Public Accountants and the Center for Audit Quality takes great care to argue only that the decision below "*could be misinterpreted* to establish a new rule that any alleged noncompliance with the Auditing Standards is always material to investors." Br. 9 (emphasis added). That would be a "misinterpretation," amici explain, because "the Second Circuit's conclusion was specific to that case and that audit." *Ibid*. Amici are right about that, but wrong that the mere possibility of misinterpretation provides a basis for certiorari. Any uncertainty about the scope of the decision is reason to deny the petition and allow the Second Circuit to clarify its position in a future case, if necessary. At that point, the Court can decide whether to intervene

if the Second Circuit rule turns out to be the one amici fear.

2. For the reasons just given, petitioner's claim that the Second Circuit departed from this Court's precedents by creating a per se materiality rule is wrong. At the same time, the court of appeals correctly rejected petitioner's proposed alternative categorical rule that a false auditing standards compliance certification is per se immaterial unless the plaintiff alleges that the audit failures affected the financial statement's accuracy. As petitioner explains at length, such categorical rules are inconsistent with this Court's materiality precedents. Pet. 26-28.

No doubt aware of the difficulty of its position—both seeking a per se rule and faulting the Second Circuit for allegedly adopting one—petitioner now tries to soften its rule by claiming there should be a "fact-specific analysis *focused on* the link between the allegedly false compliance statement and actual misstatements of financial information." Pet. i (emphasis added). That is not what petitioner argued below. There, its argument was emphatic and categorical.[5] Petitioner can hardly fault the Second

[5] *See* Pet. 9-10 (admitting petitioner argued in district court that its statement "was not materially false because the alleged noncompliance did not affect the substance of its audit report"); Petr. Motion to Dismiss 17 ("Because there is no allegation that any audit deficiencies impacted AmTrust's 'public financial reporting,' those audit deficiencies are not actionable under the securities laws, and Plaintiffs' claim fails."); BDO C.A. Br. 38-39 ("It is Appellants' burden to plead facts establishing that BDO's initial failure to complete certain audit procedures affected its 2013 Opinion.").

Circuit for failing to adopt a rule that was never proposed.

In any event, petitioner's belated attempt to "focus" the materiality inquiry on some specific area is inconsistent with the Court's rejection of artificial limits on the materiality analysis. *See, e.g.*, *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 40 (2011) (rejecting rule that would "'artificially exclude information that would otherwise be considered significant to the trading decision of a reasonable investor'") (quoting *Basic*, 485 U.S. at 236) (citation modified).

Petitioner's proposed rule is also wrong for the reasons the SEC gave. The whole point of an audit opinion is to give investors confidence that they can rely on the accuracy of a company's financial statements. An auditor's conclusions can serve that function only if the audit itself is trustworthy. So knowing whether the audit was actually completed according to required standards surely can be a matter of significance to investors trying to value a company's stock based on its financial statements in appropriate circumstances.

Petitioner insists that investors would not mind being lied to about how the audit was conducted, so long as it turns out that there was no problem for a proper audit to find. Pet. 28. But that reasoning does not hold. As the SEC pointed out, materiality is "'determined in light of the circumstances existing at the time the alleged misstatement occurred.'" SEC C.A. Br. 13 (quoting *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 165 (2d Cir. 2000)). Accordingly, for example, a radiologist would materially mislead a patient if she claimed that an MRI showed no

recurrence of cancer without reviewing the scan, even if the patient turned out to be cancer free. And an airline inspector would tell a material lie if he said a jet passed inspection after having gone through only half the required steps, even if the plane did not fall apart midair. In these examples, as with any audit, the service the defendant promised to provide was intended to afford some assurance about the extent of a risk. Failing to conduct the required examination imposes additional risk on an unwitting victim, regardless of how that risk plays out in the future.

That is why, for example, a radiologist who honestly discloses that she does not thoroughly review MRI results, or a jet manufacturer who openly admits to not completely inspecting its products, will inevitably command a lower price in the market to account for the additional risk. *Cf.* SEC C.A. Br. 5 ("[T]he lack of an unqualified opinion will be immediately noted by investors and markets, who price the attendant consequences and risks.").

Again, that does not mean that every deviation from auditing standards renders a compliance claim materially misleading, just as an airline inspector's failure to document an otherwise compliant inspection on the right form might not render his claim to have conducted a proper inspection materially misleading. But where, as here, the failures are substantial, the false reassurance can be material.

Finally, petitioner argues that the Second Circuit's interpretation of the Exchange Act "departs from this Court's express holdings" on the meaning of materiality in False Claims Act (FCA) cases like *Universal Health Servs., Inc. v. United States ex rel. Escobar*, 579 U.S. 176 (2016). Pet. 29. This argument

(raised for the first time in BDO's petition for rehearing) is meritless as well. The FCA's definition of materiality is intentionally narrower than the materiality element of a securities fraud claim. As this Court explained in *Escobar*, the FCA "defines 'material' to mean 'having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property.'" *Escobar*, 579 U.S. at 182 (quoting 31 U.S.C. § 3729(b)(4)). In contrast, the materiality element of a securities fraud claim "is satisfied when there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available." *Matrixx*, 563 U.S. at 38 (citation modified).

The FCA's more limited conception of materiality aligns with that statute's narrower "focus . . . on those who present or directly induce the submission of false or fraudulent claims" for payment to the Government. *Escobar*, 579 U.S. at 182. The Court's interpretation of that statute's distinctive materiality definition sheds little light on the question presented here, which is already addressed by an extensive, well-established body of on-point precedent with which the Second Circuit's decision fully comports.

In any event, even if the FCA's materiality standard applied here, for the reasons just discussed, a false audit certification *does* have a natural tendency to influence the price investors will pay for a stock, causing an overvaluation of the audited firm's shares by misleading markets about the degree of risk involved in relying on the company's financial statements to evaluate its worth. That is why, in this

case, AmTrust's stock price fell dramatically upon news of BDO's false certification.

## II. There Is No Circuit Conflict.

The decision below does not conflict with the law of any other circuit.

1. Petitioner's principal claim of conflict, between the decision in this case and the Sixth Circuit's 1980 decision in *Adams*, fails first because it depends on the mischaracterization of the Second Circuit opinion discussed above. It also fails because the Sixth Circuit has not adopted petitioner's proposed categorical rule either. The passage on which petitioner relies reflects instead the Sixth Circuit's application of standard materiality rules to the specific claims and facts of that case, claims and facts that are materially different from those the Second Circuit confronted here.

Unlike respondents, the plaintiff in *Adams* did not charge that the statement of compliance with auditing standards was, itself, an actionable misstatement. Instead, the plaintiff argued that the audit failures led the auditors to "fraudulently misrepresent[] material facts *about Chadbourn* by certifying the proxy financial statements." 623 F.2d at 432 (emphasis added). In other words, the auditor was charged with making false statements about the Company, not about the audit. "The question of materiality *in this context*," the Sixth Circuit held, "is whether, given all the financial information, there was a substantial risk that the actual value of assets or profits were significantly less than [the auditor] stated them to be." *Ibid*. (emphasis added).

The Sixth Circuit thus had nothing to say about a case like this, in which the plaintiffs allege not that

BDO misrepresented the state of AmTrust's finances, but whether those finances had been properly audited. It is thus unsurprising that no court has ever cited *Adams* as adopting the rule petitioner claims the case established, even though the decision has been on the books for 45 years and petitioner claims that litigation against auditors is common. In fact, as far as respondents can tell, no court has ever cited the relevant portion of *Adams* at all.[6]

Accordingly, the claim of a circuit conflict is unsupported, or at the very least premature. Further percolation is warranted to see whether petitioner's predictions about how future courts will treat these precedents come to fruition. If the issue is as recurring and important as petitioner claims, the Court should not have to wait long to find out.

2. Petitioner's attempt to substantiate a broader conflict, Pet. 16-19, fails as well. None of its cited decisions decided the Question Presented or held anything contrary to what the Second Circuit decided here. Petitioner's speculation that passages of the decisions suggest these circuits would have decided this case differently is unfounded and provides no basis for certiorari in any event.

***Third Circuit***. The Third Circuit did not decide any materiality question in *Bradford-White Corp.* v. *Ernst & Whinney*, 872 F.2d 1153 (3d Cir. 1989).

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[6] Petitioner did not cite *Adams* in its appellee brief in the Second Circuit either. *See* BDO C.A. Br. iii-vii (Table of Authorities). Nor did petitioner identify it as relevant precedent in response to respondents' petition for rehearing and the SEC's amicus brief. *See* BDO Pet. Reh. ii-iii (Table of Authorities). Instead, petitioner cited the case for the first time in its petition for rehearing.

Instead, the question before the court was whether the jury's finding of fraud relating to GAAS compliance could be "reconciled with the jury's answer to [a] special interrogatory." *Id.* at 1159. The defendant read the interrogatory answer to indicate that the financial statements themselves were not misstated, which it claimed was inconsistent with a finding that the claim of GAAS compliance was misleading. *Ibid*. The Third Circuit rejected this argument as premised on a misconstruction of the special interrogatory and so had no reason to decide whether the GAAS compliance statements could be actionable even if the financial statements themselves were accurate. *Ibid*.

The court went on to harmonize the jury's answer to various other interrogatories, concluding that the jurors found that the auditor "failed to follow GAAS when it did not uncover" certain inaccuracies in the company's books, but "complied with GAAP in the *presentation* of the incomplete data it had obtained as a result of the defective audit." *Id*. at 1160. "There was ample evidence supporting *this reading of the jury's answer* to the special interrogatory," the Third Circuit held, because "had a GAAS audit been conducted, [the auditor] would have uncovered" information that was "materially misstated in the 1980 financial statements." *Ibid*. (emphasis added). Contrary to petitioner's description (Pet. 16), the court was explaining why the evidence was *sufficient* to support the district court's *description* of the jury's answer to an interrogatory, not what evidence was *required* to prove a *material misstatement* of GAAS compliance.

***First Circuit***. The cited passage in *In re Stone & Webster, Inc.*, 414 F.3d 187 (1st Cir. 2005), addresses

compliance with the particularity requirement of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), not materiality. *See* 414 F.3d at 214 (cited by Pet. 17). The court held that, to the extent the plaintiffs alleged the audit statements were misleading because of the audit's "failure to conform to various GAAS standards," the complaint failed particularity muster because it offered only a "litany of conclusory allegations." *Ibid*. The court then addressed the additional, distinct objection that the auditor "missed various 'red flag' warning signs." *Ibid*. The court held that these allegations lacked "concreteness as to how the conduct of the audit related to the missed warning signs." *Ibid*. But this simply required that if the plaintiffs wanted to complain that the auditor's GAAS failures led it to miss some kind of red flag, the complaint had to explain in sufficient detail how the procedural failures led to the miss. The court was thus simply applying the PSLRA particularity requirement to the specific theory advanced in that case; it did not purport to establish some broad, categorical rule. And even if it had, the First Circuit required only a connection between the audit failure and the missed "warning sign," not between the audit failure and some inaccuracy in the ultimate financial statements.

***Fifth Circuit***. Petitioner's reliance on *Sioux, Ltd. v. Coopers & Lybrand*, 914 F.2d 61 (5th Cir. 1990), is particularly misplaced. There, the plaintiff alleged that a GAAS certification was misleading because the auditors failed to mention that the outcome of a particular lawsuit against the company was "subject to material uncertainty." *Id*. at 66. The Fifth Circuit simply held that this allegation was "properly submitted to the jury," without saying why. *Ibid*. If

anything, the decision undercuts petitioner's theory because the Fifth Circuit required no proof that the failure to mention the uncertain litigation against the company had any effect on the accuracy of the financial statements.

***Tenth Circuit***. Even more puzzling is petitioner's reliance on *Deephaven Private Placement Trading, Ltd. v. Grant Thornton & Co.*, 454 F.3d 1168 (10th Cir. 2006). In that case, the plaintiffs argued that a company's financial statements did not comply with generally accepted *accounting* principles and alleged that this proved that the audit did not comply with generally accepted *auditing* principles. *Id*. at 1175-77. The Tenth Circuit held this was insufficient: "Simply alleging, as Investors do, that GAAP violations in 1999 financial statements rendered [the auditor's] opinion materially false or misleading is inadequate." *Id*. at 1176. That holding has nothing to do with this case, where respondents provided direct, uncontradicted evidence of specific auditing standards violations. And that kind of showing, the Tenth Circuit expressly held, *would* be sufficient. *See ibid*. (holding that a proper "showing would, for example, specify how . . . [the auditor] did not have a reasonable basis for its opinion because it did not plan and perform its audits of the 1999 financial statements in accordance with GAAS").

***Ninth Circuit***. Petitioner cites several Ninth Circuit cases, but none conflicts with the Second Circuit's decision here.

Petitioner says that *United States v. Weiner*, 578 F.2d 757 (9th Cir. 1978), is an example of a court "focus[ing] on the statement's impact on investors." Pet. 17. But the Second Circuit likewise focused on

the misleading GAAS certification's "impact on investors," finding that the misrepresentation could reasonably mislead investors as to the reliability of the insufficiently audited financial statements. Pet. App. 36a. And the Second Circuit confirmed that in this case, the false statements directly caused respondents to suffer losses when AmTrust's stock price fell in response to investors' loss of confidence in the accuracy of the Company's financial statements in the aftermath of the audit scandal's disclosure. *Id*. 37a-38a.

Petitioner also cites a number of cases alleging false statements regarding compliance with GAAP (not, as here, *auditing* standards). Pet. 18-19. It says these cases require a plaintiff alleging false GAAP certifications to show how the accounting violation resulted in a material misstatement of the firms' "overall financial position." *Id*. at 18 (quoting *In re Daou Systems, Inc.*, 411 F.3d 1006, 1018 (9th Cir. 2005)). Even if that were an accurate description of those decisions, the rules for cases alleging GAAP violations do not transfer automatically or easily to cases alleging false auditing standards compliance certifications.

For one thing, as in *Daou Systems*, GAAP cases are usually brought against the company and its officers, not the auditor. *See* 411 F.3d at 1012. For another, the claim is typically not that the defendants falsely certified that the financial statements were GAAP-compliant, but rather that the financial statements themselves were misleading—*e.g.*, the company overstated revenue. *See id*. at 1016 (characterizing claim as one regarding "overstating of revenues") (citation omitted); *Gebhardt v. ConAgra*

*Foods, Inc.*, 335 F.3d 824, 830 (8th Cir. 2003) ("The keystone of plaintiffs' materiality argument is their allegation that [a subsidiary's] misrepresentations caused ConAgra to appear to be earning more than it was."). GAAP compliance is relevant to such claims because investors understand terms like "revenue" in light of the GAAP principles declaring what counts as "revenue" for accounting purposes.

Accordingly, false GAAP certifications "may support a plaintiff's claim of fraud" *because* they result in "overstatement of revenues." *Daou Systems*, 411 F.3d at 1018. It is therefore only natural that to prevail on an overstatement-of-revenue theory, the plaintiff "must show with particularity how the adjustments affected the company's financial statements and whether they were material in light of the company's overall financial position." *Ibid.*; *see also Gebhardt*, 335 F.3d at 830.

The theory of liability in an auditing standards compliance case like this one is very different—the fraud does not lie in misleading investors about what reported "revenue" represents, but in giving investors a false assurance about the level of risk that the financial statements may be inaccurate. *See* Pet. App. 36a. Given this, it is no surprise that petitioner is unable to cite any circuit cases applying the rules for GAAP violation cases to ones alleging misleading auditing standards compliance certifications. Until such a case arises, petitioner's insistence that courts *should* apply the same rules in both contexts is no basis for claiming a circuit conflict or for this Court's review.

## III. The Question Presented Is Not Recurringly Important.

The Question Presented also is not sufficiently recurring and important to warrant review, particularly in the absence of a significant circuit conflict.

The general law of materiality is well settled and deciding the Question Presented would provide additional clarity only with respect to one very specific kind of statement. Petitioner does not show that the materiality of an auditor's auditing standards compliance certification comes up with any regularity, citing no more than a handful of cases even arguably touching on the question over the past 50 years. *See* Pet. 12-19.

Instead, the petition's claims of importance depend almost entirely on its mischaracterization of the Second Circuit opinion as "massively expand[ing] potential liability" by making auditors categorically liable for minor audit errors. Pet. 20-21; *see also id*. 21 (claiming that the Second Circuit's ruling subjects half of audit companies to suit given prevalence of minor errors). But as discussed, the premise of those breathless claims is false—the Second Circuit did not hold that a certification is rendered materially misleading by minor violations of audit rules. The court simply rejected petitioner's categorical rule that an auditor can falsely claim to have complied with auditing standards with impunity, even if the auditor

conducted no real audit at all, so long as it turns out after the fact that the financials were not misstated.[7]

In addition to depending on a mischaracterization of the decision below, petitioner's argument ignores that materiality is simply one of many elements in a securities fraud claim, such as scienter, loss causation, and reliance. *See* SEC C.A. Br. 14.[8] For example, even when a misrepresentation about compliance is material, plaintiffs still must show that it caused them a loss to establish loss causation and prove damages.

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[7] For this reason, there is no basis for petitioner's claim (Pet. 23-24) that the decision below will draw litigation against auditors to the Second Circuit, particularly given petitioner's failure to show that any other circuit applies a more auditor-friendly rule.

[8] Petitioner argues that scienter and loss causation are not required under Sections 11 and 12(a)(2) of the Securities Act or 18 of the Exchange Act. Pet. 22. While correct, petitioner tells an incomplete story. *See* 15 U.S.C. § 77k(b)(3) (provision of Section 11 allowing some defendants a due-diligence defense); *id*. § 77l(l) (same for loss causation under Section 12); 15 U.S.C. § 78r(a) (good faith defense to Section 18 liability). Petitioner further ignores other requirements and limitations in these provisions. *See, e.g.*, 15 U.S.C. §§ 77k (e) (Section 11 limitation on damages); *id*. § 77l(a) (same for Section 12); 15 U.S.C. § 77r(a) (requiring proof of reliance in Section 18 actions). These, together with the substantial protections enacted in the PSLRA, amply protect auditor defendants against "existential liability." Pet. 22. *See Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, 568 U.S. 455, 475-76 (2013) (PSLRA imposes "heightened pleading requirements' for securities fraud actions, limit[s] recoverable damages and attorney's fees, provide[s] a 'safe harbor' for forward-looking statements, impose[s] new restrictions on the selection of (and compensation awarded to) lead plaintiffs, mandate[s] imposition of sanctions for frivolous litigation, and authorize[s] a stay of discovery pending resolution of any motion to dismiss.") (citation modified).

That will be most easily accomplished when an auditing error leads to publication of a materially erroneous financial statement, cases in which petitioner acknowledges materiality is established. This is the unusual case in which respondents were able to plead damages and loss causation without regard to financial misstatements due to the circumstance that the audit errors were revealed after the market had already priced in the restatement of AmTrust's financial statements, yet the announcement caused an additional drop in the stock price. *See supra* p. 9.[9]

All that said, if the question becomes recurring in the future, if the Second Circuit treats the decision in this case as establishing the rule petitioner and its amici fear or extends it to other contexts, if litigation challenging auditing standards compliance certifications by auditors explodes, or if petitioner's prophesy of catastrophic practical harm materializes, this Court will have ample opportunity to intervene at that time.

## IV. This Case Is A Poor Vehicle.

Even if the petition presented an otherwise cert-worthy question, this case is a poor vehicle for addressing it, for two reasons.

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[9] Petitioner also points out that the SEC need not prove reliance in a Section 10(b) enforcement proceeding. Pet. 22-23. But in addition to Congress's well-founded assumption that the SEC will not expend its scarce resources on petty cases, petitioner admits that the SEC must still prove scienter and materiality on the facts of each case. *Ibid.*

***First***, petitioner has waffled over what rule it is advancing. Below, petitioner unabashedly argued for a categorical rule. *See supra* p. 13. In this Court, however, petitioner appears (at times) to advance a different rule: that courts should conduct a "fact-specific analysis *focused* on the link between the allegedly false compliance statement and actual misstatements of financial information." Pet. i (emphasis added). This equivocating—and petitioner's failure to acknowledge its change in position—raises questions about precisely what rule it would ask this Court to adopt if certiorari were granted and whether that argument was adequately preserved below.

***Second***, the case is a poor vehicle because petitioner has not shown that its proposed standard would make any difference to the outcome.

Petitioner argues that it would prevail under its proposed rule because the Second Circuit stated in its original opinion that respondents failed to allege a link between the audit failures and the financial misstatements. Pet. 25 (citing Pet. App. 75a). But petitioner ignores that respondents challenged that conclusion in their petition for panel rehearing and that, in response, the Second Circuit withdrew the finding from its final opinion. *See supra* p. 9.

In fact, petitioner's claim (Pet. 8) that respondents "allege . . . that BDO promptly cured its audit and discovered no misstatements needing public correction" is false. The Complaint alleges, and petitioner does not dispute, that the financial statements to which BDO gave an unqualified opinion were, in fact, seriously inaccurate, requiring a substantial restatement. Pet. 6-7. The Complaint

further alleges, and petitioner does not deny, that the SEC found that as a result of the audit failures, auditors "'did not have sufficient audit evidence to support BDO's audit report.'" C.A.J.A. 250 (Complaint ¶ 632 (quoting SEC Order ¶ 31)). Petitioner argues instead that those extraordinary audit violations had no effect on the financial statements because the very individuals at BDO responsible for the violations were the ones who later claimed that the failures made no difference to their conclusions. Pet 8.

But the Complaint explained that petitioner's claim of harmless error is not credible. Complaint ¶¶ 612-13. A conclusion that the belated review had called the financial statements into question would have required BDO to publicly disclose that it had changed its audit opinion, and admit that the very individuals who conducted the belated review were the same individuals who previously issued an unqualified opinion, despite not actually completing their audit. *Ibid*. Declaring that the audit steps undertaken after the issuance of the unqualified audit opinion made no difference to the outcome conveniently relieved the auditors of that responsibility and held open that their failures might never reach the light of day. Perhaps this is why the SEC recounted the auditors' claims of harmless error in its Order, but did not find that the claims were true. SEC Order ¶ 30. Instead, despite the auditors' contention that the audit violations had made no difference to their opinion, the Commission suspended the auditors who made that claim for three years. *Id*. § IV.

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

Kevin K. Russell
*Counsel of Record*
RUSSELL & WOOFTER LLC
1701 Pennsylvania Ave. NW
Suite 200
Washington, DC 20006
(202) 240-8433
*kr@russellwoofter.com*

Samuel H Rudman
David A. Rosenfeld
Robert D. Gerson
Mark T. Millkey
ROBBINS GELLER
RUDMAN & DOWD LLP
58 S. Service Rd.
Suite 200
Melville, NY 11747

Andrew Love
ROBBINS GELLER
RUDMAN & DOWD LLP
Post Montgomery Ctr.
One Montgomery Street,
Suite 1800
San Francisco, CA 94104

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