No. 24-1151

In the Supreme Court of the United States

BDO USA, LLP,

Petitioner,

v.

NEW ENGLAND CARPENTERS GUARANTEED ANNUITY AND PENSION FUNDS; STANLEY NEWMARK, IRVING LIGHTMAN REVOCABLE LIVING TRUST, JUPITER CAPITAL MANAGEMENT, JOHN SACHETTI, Individually and On Behalf of All Others Similarly Situated; and JOEL RUBEL, Individually and On Behalf of All Others Similarly Situated,

Respondents.

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

REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

The decision below creates a *per se* rule of materiality: In the Second Circuit, an auditor's standardized statement of compliance with auditing standards, if false, is now *necessarily* material, with no fact-specific allegations of materiality required.

That outcome is irreconcilable with this Court's repeated rejection of "[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality." *Matrixx Initiatives, Inc.* v. *Siracusano*, 563 U.S. 27, 39 (2011) (quoting *Basic, Inc.* v. *Levinson*, 485 U.S. 224, 236 (1988)). It conflicts squarely with the Sixth Circuit's contrary rule. And it has disastrous consequences for accounting firms, which will now face significant liability for anodyne misstatements of compliance.

Respondents apparently recognize that the Second Circuit's *per se* rule of materiality is indefensible. Their primary strategy in opposing certiorari is therefore to deny that the rule exists.

But that strained reading disregards the plain language of the opinion, which held BDO's alleged misstatement material solely because its "standardized language * * * conveyed to investors that [the] audited financial statements were reliable," and thus its alleged falsity "subjected unknowing investors to the risk that [the] financial statements were unreliable." Pet. App. 36a. To state the obvious: That generic reasoning will be true of *every* compliance statement issued by *every* auditor that signs off on *any* company's financial statements. It is therefore a *per se* rule.

The Court should grant certiorari.

A. The decision below turns on an erroneous *per se* rule of materiality.

1. *The court of appeals held that false statements of PCAOB compliance are* per se *material.*

a. Respondents' opposition reduces to a single assertion: "the court of appeals did not adopt any categorical rule." BIO 10.

Respectfully, respondents must be reading a different opinion. After noting that BDO's "challenged audit certification reflects standardized language"—that is, it uses standardized language tracking the relevant standard prescribed by AU 508.08—the Second Circuit's materiality analysis proceeded in just four sentences (Pet. App. 36a), none of which involved anything specific to this case:

> **(1)** "BDO's certification that the audit was conducted in accordance with PCAOB standards succinctly conveyed to investors that AmTrust's audited financial statements were reliable."

This premise is equally applicable to any compliance statement attached to any unqualified audit opinion.

> **(2)** "The absence of BDO's certification would have been significant, for without it, BDO could not have issued an unqualified opinion, AU 508.07, which then would have alerted investors to potential problems in the company's financial reports, *see United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984)."

Again, nothing is specific to BDO; the court restates the governing auditing standard—which prohibits an

unqualified opinion unless all procedures were followed (AU 508.07)—and then provides a near-verbatim paraphrase of this Court's discussion of a *generic* hypothetical scenario. See *Arthur Young*, 465 U.S. at 818 (explaining that, if an auditor issues anything other than an unqualified opinion, that would "notify[] the investing public of possible potential problems inherent in the corporation's financial reports"). Once again, no case-specific analysis.

> **(3)** "The false certification thus subjected unknowing investors to the risk that AmTrust's financial statements were unreliable."

This statement, which follows from the previous two, would be true of any false certification of GAAS or PCAOB compliance.

> **(4)** "For that reason, contrary to the District Court's conclusion, the 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."

"[T]hat reason" refers to what the court said in the prior three sentences: False certifications of auditing standard compliance are *inherently* material, because if no certification were made, investors would suspect financial problems.

That is a categorical rule. It holds that BDO's statement was material not because of anything *particular* to that statement (which, being standardized, had nothing particular about it) or the surrounding circumstances, but merely because the statement was

allegedly false. As the Second Circuit now holds, this kind of alleged misrepresentation is *always* material.

b. Respondents attempt sleight-of-hand to argue otherwise. They string together the lower court's recitation of its pleading standard (considering how "reasonable minds" might consider the "importance" of "alleged misstatements") with the court's statements in a separate paragraph regarding the "potential problems" audit misstatements generally might conceal. BIO 11-12 (quoting Pet. App. 36a).[1] Between those quotes, respondents sandwich the assertion that the court below made a finding about the alleged "audit failures in this case." BIO 11-12. That is pure invention. In reversing the district court on materiality, the court said nothing whatsoever specific to the allegations of this case. Respondents' clandestine effort to rewrite the lower court's analysis proves our point—the court adopted a *per se* rule.[2]

c. The categorical nature of this holding is confirmed by the court's shift upon rehearing. In its original opinion, the court correctly found no materiality because "the Complaint fails to allege any link between BDO's misstatements" and "errors contained in

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[1] The quoted language about "potential problems" is lifted from *Arthur Young*, which describes what happens when *any* auditor fails to issue an unqualified opinion. 465 U.S. at 818. It is not specific to the allegations here.

[2] Respondents make much of a sentence in one *amicus* brief. BIO 1-2, 12 (citing Center for Audit Quality Br. 9). *Amici*'s effort to soften the blow of the decision below stems from concerns about the foreboding consequences it will cause absent review. As all other *amici* recognize, the lower court adopted a *per se* rule. Pages 2-4, *supra*; Chamber Br. 3; Professors Br. 2-3; Washington Legal Foundation Br. 1-2.

AmTrust's 2013 Form 10-K" and, further, "*in this case,* as the District Court held, Appellants have failed 'to allege any facts relevant to'" whether or how BDO's alleged noncompliance "'would have been significant to a reasonable investor in making investment decisions.'" Pet. App. 75a-76a (quoting *id.* at 153a). The court acknowledged that it "might have come to a different conclusion had such facts been alleged." *Id.* at 76a.[3] *This* was non-categorical, case-specific analysis.

Then came rehearing briefing, in which the SEC transparently called for a categorical rule, urging that a statement of PCAOB compliance "has independent significance" and therefore inherently "matters to investors regardless of whether the specific deficiencies resulted in misstated financial statements." C.A. Dkt. 202, at 13.

The resulting opinion on rehearing does not newly identify "any facts relevant to" how BDO's conduct "would have been significant to a reasonable investor." Pet. App. 76a. Rather, it finds that inquiry unnecessary, because even a "standardized" statement of

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[3] This remark in the original opinion—endorsing *BDO's* position—disproves respondents' puzzling contention that it is actually *BDO* who supports a categorical rule. BIO 2, 13, 27. Our position, that courts must always look to the specific facts in each case when assessing materiality, follows immediately from *Basic*; respondents grasp at straws in asserting (BIO 13) that this is itself an impermissible *per se* standard.

Nor has BDO altered its position. Cf. BIO 13, 27. BDO has consistently advanced the same argument it will make at the merits stage—materiality requires fact-specific analysis considering whether the particular alleged auditor misstatement had bearing on reasonable investors. See, *e.g.,* BDO's Motion to Dismiss, D. Ct. Dkt. 184. That is just what the court of appeals first held before changing course. Pet. App. 75a.

PCAOB compliance, if false, necessarily "subject[s] unknowing investors to the risk that [the audited] financial statements were unreliable." *Id.* at 36a.

The court thus accepted the SEC's invitation to adopt an unprecedented *per se* rule under which no allegedly false statement of PCAOB compliance could ever fail to be material.[4] That extraordinary holding warrants review.

2. The outcome turned on that categorical rule.

Respondents assert that BDO's motion would fail under the proper materiality standard, suggesting a vehicle problem. BIO 27-28. But this case *has already been litigated* under that standard, and BDO *won*. In its original opinion, the Second Circuit affirmed the district court's finding that respondents failed to plead materiality, because "the Complaint fails to allege any link between BDO's misstatements * * * and the material errors contained in AmTrust's 2013 Form 10-K," or any other "facts relevant to" whether the alleged PCAOB noncompliance "would have been

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[4] Respondents' protestation that "a minor deviation from auditing standards" does not "render[] a certification materially false" under the Second Circuit's rule (BIO 12, 15) is difficult to understand. The Second Circuit's reasoning has nothing to do with the magnitude of an auditor's noncompliance with auditing standards; it turns instead on the auditor's inability to properly "issue[] an unqualified opinion" absent compliance. Pet. App. 36a; see pages 2-4, *supra*. But under the governing rules, an unqualified opinion requires *full compliance*, not substantial compliance, with auditing standards. See AU 508.07; PCAOB Auditing Standard ("AS") 3101.02, .09(c). The Second Circuit's reasoning thus applies equally to all alleged noncompliance.

significant to a reasonable investor in making investment decisions." Pet. App. 75a-76a.

It was only after the Second Circuit reversed its legal holding on rehearing—announcing that respondents "were not *required* to allege a link between BDO's false certification and specific errors in AmTrust's financial statements" because such certifications are necessarily relevant to investors (Pet. App. 36a (emphasis added))—that respondents prevailed. Nothing about the court's reading of respondents' complaint changed. Only the legal rule driving the analysis did.

Respondents seem to suggest that in replacing its earlier decision (that "the Complaint fails to allege any link" between BDO's compliance certification and errors in the financial statements) with its later one (that respondents "were not required to allege" such "a link"), the Second Circuit was actually holding that respondents *had* alleged that link. BIO 27. But the opinion says no such thing.

The court of appeals never disrupted the district court's core conclusion: Taking respondents' allegations as true, BDO's conduct "ultimately had no effect on the 2013 audit opinion." Pet. App. 153a. The Second Circuit's novel *per se* materiality rule thus dictated the new outcome.

3. The decision below is wrong.

It is little surprise that respondents avoid defending the *per se* standard adopted below. As the petition explains (at 26-33) and respondents appear to largely concede (BIO 13), a "bright-line" rule holding certain statements *always* material is squarely foreclosed. *Basic*, 485 U.S. at 236; *Matrixx*, 563 U.S. at 40. But again, that is precisely what the Second Circuit's

opinion entails: Its analysis is entirely abstracted from the specific facts of this case; it would apply just as readily to *any* unqualified opinion issued by *any* auditor. See pages 2-4, *supra*.

Respondents do dispute that this Court's False Claims Act materiality jurisprudence is relevant. BIO 15-17. But in *Escobar*—the leading FCA materiality case—the Court repeatedly drew upon securities precedents, characterizing them as holding that "materiality *cannot rest* on 'a single fact or occurrence as always determinative.'" *Universal Health Servs., Inc.* v. *United States ex rel. Escobar*, 579 U.S. 176, 188 n.3, 191 (2016) (quoting *Matrixx*, 563 U.S. at 39) (emphasis added). The Court's holding that a statement of compliance with governing regulations is not "automatically material" (*id.* at 191) thus further demonstrates why the same logic, applied to statements of PCAOB compliance, cannot stand.

B. The decision below creates a circuit split.

1. The petition explained that the Second Circuit's *per se* rule opens a circuit conflict. Pet. 12-19. Respondents' principal answer—its steadfast denial that the Second Circuit created such a rule—simply lacks credibility. Pages 2-6, *supra*.

To avoid the lower court's clear conflict with *Adams* v. *Standard Knitting Mills, Inc.*, 623 F.2d 422, 432 (6th Cir. 1980), respondents assert that, unlike them, "the plaintiff in *Adams* did not charge that the statement of compliance with auditing standards was, itself, an actionable misstatement." BIO 17. That is flatly incorrect. There, "[t]he District Judge found that [the auditor's conduct] constituted a departure from GAAS, *and therefore made its certification a*

material misrepresentation." 623 F.2d at 435 (emphasis added); see also *ibid.* (rejecting that conclusion).

The *Adams* district court decision—which the petition raised but respondents conspicuously do not address—is even more blunt: One of "Plaintiffs' Contentions" was that the auditor's "failure to disclose that [the audit] was not conducted in accordance with generally accepted auditing standards and principles (GAAS and GAAP) constituted a material omission." *Adams* v. *Standard Knitting Mills, Inc.*, 1976 WL 821, at *3 (E.D. Tenn. 1976). The district court agreed, holding that "had [the auditor] properly described and disclosed" its noncompliance (including noncompliance with auditing standards), "plaintiffs would have considered it important." *Id.* at *17-20.

That is what the Sixth Circuit rejected, holding instead that materiality requires "a substantial risk that the actual value of assets or profits were significantly less than [the auditor] stated them to be." 623 F.2d at 432; see also *id.* at 434 (rejecting materiality because "Plaintiffs have not proved" a "material risk that a proper audit of the standard cost system would have revealed materially lower costs"). That approach is flatly incompatible with the Second Circuit's *per se* rule.

2. Respondents cannot explain away the other inconsistent decisions.

Respondents disregard our explanation that *Bradford-White Corp.* v. *Ernst & Whinney*, 872 F.2d 1153 (3d Cir. 1989), is relevant for its "starting premise." Pet. 16. The court rejected an auditor's argument that it could not be liable for falsely "represent[ing] that it had complied with GAAS" in conducting an audit when the jury had also found that "the overall

financials [of the audited company] were not misstated." 872 F.2d at 1159. If the Second Circuit were right that a misrepresentation of GAAS or PCAOB compliance is material without any "link between" that certification and "specific errors in [the] financial statements" (Pet. App. 36a), there would have been no inconsistencies between these two findings for the Third Circuit to "harmonize." BIO 19.

Respondents note (BIO 19-20) that *In re Stone & Webster, Inc,* 414 F.3d 187, 214 (1st Cir. 2005), focused on particularity. True, but that misses the point. The decision shows that false statements of GAAS compliance support liability where that noncompliance led to the auditor's "failure to discover * * * deviations from GAAP in the accounting," whereas allegations resting solely on "failure to conform to various GAAS standards," without more, do not. *Ibid.*

Respondents also misunderstand the significance of *Sioux, Ltd.* v. *Coopers & Lybrand*, 914 F.2d 61, 66 (5th Cir. 1990) and *United States* v. *Weiner*, 578 F.2d 757, 779 (9th Cir. 1978). BIO 20-22. In both cases, materiality was supported not just by GAAS noncompliance, but concrete investor-relevant information communicated or omitted *because* of the GAAS noncompliance, such as risky litigation (*Sioux*, 914 F.2d at 66) or misreported figures (*Weiner*, 578 F.2d at 779).

Lastly, respondents downplay the relevance of cases involving certifications of GAAP compliance, as opposed to GAAS compliance. BIO 22-23. Respondents note that in GAAP cases, "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." *Ibid.* (citing *In re Daou Systems, Inc.*, 411

F.3d 1006, 1018 (9th Cir. 2005); *Gebhardt* v. *ConAgra Foods, Inc.*, 335 F.3d 824, 830 (8th Cir. 2003)).

But by the logic of the *per se* rule adopted below, securities plaintiffs would not *need* to show how failure to adhere to GAAP undermined the substance of the company's financial statements. They could simply attack technical noncompliance with GAAP itself. As respondents observe, plaintiffs never do that (or, at least, never *did*) because GAAP noncompliance alone cannot establish materiality.

The same has been true of statements of GAAS compliance—until now.

C. Review is urgently needed.

Finally, the petition explained (at 23-25) that the opinion below is disastrous for auditors and others: The predictable consequence of its expansion of liability is a flood of vexatious litigation in the Second Circuit. Several *amici* expand on those concerns. See generally Chamber Br.; Professors Br. 13-17; Washington Legal Foundation Br. 8-9.

Respondents suggest that review is unnecessary because "the general law of materiality is well-settled" and this case implicates "one very specific kind of statement" that respondents say is not often targeted. BIO 24. Indeed, the general law of materiality *was* well-settled, and for that reason it *had* been rare for plaintiffs to argue that an auditor's false statement of GAAS compliance, alone, established securities fraud liability.

But the Second Circuit's decision will upend that equilibrium: Per the PCAOB itself, as many as 46% of the thousands of audits conducted annually involve noncompliance with relatively minor PCAOB

procedures; in the Second Circuit, 46% of audit certifications are now not just false, but materially so. Pet. 21. Prompt review is imperative to preclude the coming avalanche of claims.

Contrary to respondents' assertion (BIO 18, 26), this is an ideal vehicle for review. The juxtaposition between the Second Circuit's original decision and rehearing decision starkly reveals that the outcome turns on a singular legal question. And respondents have no answer to our demonstration (at 23-25) that, because venue is virtually always available in the Second Circuit, this issue is likely to evade future review. Since plaintiffs will flock to the Second Circuit, the issue is unlikely to arise elsewhere. And few defendants will see litigation threatening such crushing liability through to the end, simply for hopes of ultimate review by this Court.

Finally, respondents argue that the *per se* rule adopted below is inconsequential because Section 10 contains other elements, like scienter and loss causation. BIO 25 n.8. But they are forced to admit that many other securities statutes lack these elements. *Ibid.*; see Pet. 22; Chamber Br. 4-9.

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This Court has long cautioned against adopting "bright-line rule[s]" to govern the "inherently fact-specific" materiality inquiry. *Basic*, 485 U.S. at 236; see *Matrixx*, 563 U.S. at 38; *Escobar*, 579 U.S. at 191. But the decision below does just that—and in so doing, it opens a circuit split and exposes auditors to unwarranted new liability. Review is warranted.

CONCLUSION

The Court should grant the petition.

Respectfully submitted.

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