

May 2, 2011

Ninth Circuit Reverses Dismissal of Securities Fraud Class Action Where Complaint was "Loaded with Specific Allegations" to Support a Strong Inference of Scienter

In [*New Mexico State Investment Council v. Ernst & Young LLP*](#), 2011 WL 1419642 (9th Cir. Apr. 14, 2011), the [United States Court of Appeals for the Ninth Circuit](#) reversed the dismissal of securities fraud claims against an independent accountant, holding that the complaint pleaded particularized facts giving rise to a strong inference that the auditor acted with scienter when it certified the financial statements of its client, Broadcom Corporation ("Broadcom"). In doing so, the Ninth Circuit declined to apply a "rule of thumb" that a plaintiff bears a "heavier burden" in pleading a strong inference of scienter against an independent accountant than it would in a similar securities fraud action against an issuer or its executives.

This class action was filed in October 2008 naming Broadcom and its auditor in connection with alleged stock option backdating. Plaintiffs alleged that between 2000 and 2006, Broadcom understated its income expenses by more than \$2.2 billion, "largely due to improper backdating." Broadcom agreed to pay a civil penalty of \$12 million to the [Securities and Exchange Commission](#) in connection with these allegations.

The "crux" of lead plaintiff's claim against the auditor focused on an unqualified opinion letter in 2005. In that letter, which covered financial years 2003-2005, the auditor stated that Broadcom's financial statements presented "fairly, in all material respects, the consolidated financial positions of Broadcom Corporation" and that "the consolidated results of its operations and its cashflows" for the financial years 2003-2005 were "in conformity with generally accepted accounting principles ('GAAP')." Plaintiffs alleged that this opinion letter was "materially false and misleading due to Broadcom's stock option backdating scheme" and that the auditor was "complicit in a stock option backdating scheme involving a stock option backdating scheme involving options to purchase over 239 million shares of Broadcom stock between 1998 and 2005." Plaintiffs alleged further that the auditor either "knew, or was deliberately reckless in not knowing," about Broadcom's fraudulent option backdating accounting practices.

The auditor filed a motion to dismiss, asserting that the complaint failed to plead a strong inference of its scienter — actual knowledge — regarding Broadcom's accounting fraud. The [United States District Court for the Central District of California](#) agreed. In February 2009,

granted the auditor's motion to dismiss, stating that plaintiffs' allegations were "deficient on actual knowledge" of the auditor and that the standard for pleading fraud against independent accountants was "a little bit of a heavier burden," which lead plaintiff had failed to meet.

On appeal, the question before the Ninth Circuit was whether, under [15 U.S.C. § 78u-4\(b\)\(2\)\(A\)](#), lead plaintiff's complaint adequately stated "with particularity facts giving rise to a strong inference that" the auditor "acted with the required state of mind." Under [Tellabs, Inc. v. Makor Issues & Rights Ltd.](#), 551 U.S. 308 (2007) [see blog article [here](#)], plaintiffs' complaint would survive dismissal "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." This required the Court to compare "the malicious and innocent inferences cognizable from the facts pled in the complaint, and only allow the complaint to survive a motion to dismiss if the malicious inference is at least as compelling as any opposing innocent inference." Contrary to the district court's analysis, the Ninth Circuit held that there is no "rule of thumb" for determining whether an independent accountant had the requisite scienter to support an accounting fraud claim.

With this standard in mind, the Ninth Circuit principally considered three key factual allegations regarding the auditor's scienter: (1) its knowledge regarding Broadcom's backdated option grants in May 2000, (2) option grants when the compensation committee was not legally constituted and (3) involvement in Broadcom's 2003 corrective reforms.

The Court first addressed the auditor's knowledge regarding backdated options in May 2000. The Court started with the observation that, although option backdating — the practice of dating an option back in time to a date certain, usually when the share price was at a low ebb, which the Court analogized to "betting on a horse race after the horse has already crossed the finish line" — is "not in and of itself improper," a company issuing such "in the money options" must account for such options as "profit" and must treat the options as compensation to the option recipient over the vesting period. Broadcom's May 2000 stock option grants were not properly recorded as profit, and therefore the 2005 opinion letter for the years 2003-2005 — the vesting period for the backdated options — materially overstated Broadcom's net reported income.

The question before the Ninth Circuit, however, was whether the auditor issued an incorrect clean audit opinion knowingly. The Court concluded that the allegations of the complaint strongly suggested that auditor had such knowledge or was deliberately reckless in ignoring "red flags." The Court started with the fact that the May 2000 options were "the largest option grant in [Broadcom's] young history" and was "suspicious not only in its timing but its relative

size.” Specific emails cited in the complaint strongly suggested that the auditors were suspicious of how Broadcom had accounted for the backdated options, but failed to fully investigate the backdated option grant. For example, after pressing Broadcom’s chief financial officer (“CFO”) regarding the backdated option, Broadcom’s CFO claimed that the options were awarded pursuant to a “Guideline Matrix program.” The auditor, however, allegedly never saw this matrix and “apparently accepted [Broadcom’s] management at it word.”

The Court held that this was sufficient to support an inference that the auditor knew or was reckless in not knowing of material inaccuracies in Broadcom’s financial statements. Nor could the auditor show that there was a “more compelling innocent inference” to be drawn from these circumstances. Though the auditor argued that this was, at worst, mere negligence, the Court found this implausible, declaring broadly that “an auditor, in fulfilling duties of public trust, should take a long hard look at a transaction of \$700 million Broadcom’s auditor owe[d] its ultimate allegiance to the company’s creditors and stockholders, as well as to the investing public.”

The Court then turned to plaintiffs’ second main factual allegation supporting an inference of scienter: that the option grants were made when the compensation committee was not legally constituted. Under Broadcom’s bylaws, “the board of directors compensation committee possessed the sole authority to issue stock option grants to Broadcom’s officers.” The compensation committee had just two members. Between June 2001 and December 2001, this committee approved a number of stock option grants to Broadcom’s employees. During this period, however, one of the two members of the committee had passed away, leaving the committee without a quorum to actually approve such grants. Plaintiffs alleged that the auditor accepted unsigned committee minutes approving these grants despite the fact that they required a signature from a dead committee member.

The Court held that these allegations also raised a strong inference of the auditor’s scienter. The Court held that while “Broadcom executives may have attempted to deceive” the auditor, there was “an equal inference that” the auditor “overlooked significant events without further questioning or investigation.” This “failure to follow up” and subsequent willingness to sign off on these false option grants was sufficient to “plead[] an audit so deficient that the audit amounted to no audit at all.”

Third, the Court turned to the allegation that the auditor was involved in Broadcom’s 2003 corrective reforms and, by its involvement, knew or was deliberately reckless in not knowing of “the irregularities in Broadcom’s option granting process.” The auditor argued that these reforms were required by the Sarbanes-Oxley Act. The Ninth Circuit rejected this argument, observing that Broadcom had already completed its Sarbanes-Oxley Act reforms “before the

implementation” of the 2003 corrective reforms. In any event, despite the fact that the reforms took place in 2003 — some three years after the backdated options were granted — the auditor “apparently took no action to revisit the audits of its earlier grants or to inform creditors, stockholders, or the investing public as it was required to do.”

The Court then reviewed a number of more minor allegations, including that the backdated options lacked contemporaneous documentation, the audit did not comply with generally accepted audit standards, option dates that were sporadic, suspiciously long delays occurred between the award of stock options and the compensation committee’s grant of such an award and option grant dates were set at or near the low stock price for a given quarter which soon were followed by a surge in Broadcom’s share price. In light of all of these allegations, the Court held that plaintiffs’ complaint was “loaded with specific allegations of how and why [the auditor] should have investigated deficient or missing documentation.”

The most significant aspect of this case is the Court’s apparent rejection of a “rule of thumb” suggesting that plaintiffs face a higher burden when attempting to plead an auditor’s scienter, as well as the Court’s broad declaration of a duty supposedly owed by auditors to “the investing public.” That said, this decision ultimately is quite narrow. Unlike many securities fraud complaints, the complaint here was “loaded with specific allegations” supportive of a strong inference of the auditor’s scienter in connection with a particularly egregious and unique financial scandal that is not likely to be replicated elsewhere.

For further information, please contact [John Stigi](#) at (310) 228-3717 or [Martin White](#) at (415) 774-3233.