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Tenth Circuit Affirms High Standard For Scienter Pleading In Securities Fraud Cases Against Independent Auditors

In *Dronsejko v. Grant Thornton*, Nos. 09-4222 and 10-4074, U.S. App. LEXIS 1052 (10th Cir. Jan. 20, 2011), the United States Court of Appeals for the Tenth Circuit affirmed a decision by the United States District Court for the District of Utah dismissing a securities fraud class action brought by investors in iMergent against its independent auditor, Grant Thornton. The district court held that the operative complaint failed to plead particularized facts sufficient to give rise to a strong inference that Grant Thornton possessed the scienter required to support liability under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5. Plaintiffs also sought relief from the dismissal under Rule 60(b) of the Federal Rules of Civil Procedure, asserting that subsequent orders by the Public Company Accounting Oversight Board ("PCAOB") issuing sanctions against two Grant Thornton auditors for their conduct in auditing iMergent's financial statements added new evidence to their claims. The district court denied plaintiffs' Rule 60(b) motion. The Tenth Circuit affirmed both decisions, reiterating the high standards for pleading a securities fraud claim against an independent auditor.

The Underlying Case and District Court Rulings

iMergent is an e-services company that licensed software designed to help small businesses engage in e-commerce. In 2005, the Securities & Exchange Commission ("SEC") commenced an inquiry into iMergent's revenue recognition practices regarding its Extended Payment Term Arrangements ("EPTAs"). EPTAs allowed iMergent customers to pay for software purchases in installments spread across a twenty-four month period. At the time of this inquiry, iMergent recognized 100% of the revenue from these sales at the time of the delivery of the product, despite an average collection rate of only 53% of the total purchase price for these sales. Grant Thorton issued "clean" opinions of the iMergent financial statements reflecting this revenue recognition policy.

iMergent responded by contending that its EPTA collection rates exceeded 50% and, therefore, the EPTA revenue was recognizable at the time of the license delivery under American Institute of Certified Public Accountants Statement of Position ("SOP") 97-2. Under SOP 97-2, a company may recognize revenue immediately from software license sales subject to extended term contracts if "(1) persuasive evidence of an arrangement exists; (2) delivery of the product has occurred; (3) the fee is fixed and determinable; and (4) collectability is probable." iMergent claimed its 53% collection rate met the "probable" collectability requirement.

The SEC disagreed with this assessment of "probable," stating that a company must have a collection rate "substantially" higher than 50% in order to make collection "probable" within the meaning of SOP 97-2. Following this communication from the SEC, Grant Thornton withdrew its audit opinions on iMergent's financial statements, iMergent changed its revenue recognition policies and iMergent issued restatements of its financial statements for fiscal years 2002 through 2004. The restatements lowered the revenues reported by the company, turning earnings reported for these three years into losses,

causing iMergent stock price to drop.

Investors sued. After settlements with iMergent and its officers and directors, Grant Thornton was the sole defendant left in the litigation.

Plaintiffs alleged that Grant Thornton violated Section 10(b) and Rule 10b-5 by falsely certifying that iMergent's financial statements complied with generally accepting accounting principles and representing that their audits complied with generally accepted audit standards. Particularly, plaintiffs alleged that Grant Thornton acted "recklessly" when reaching the conclusion that iMergent's 53% collection rate on its EPTAs satisfied SOP 97-2's "probable" collection standard.

The district court granted Grant Thornton's motion to dismiss. It held that plaintiffs failed to plead facts giving rise to a strong inference that Grant Thornton's use of a 53% collection rate threshold was sufficiently reckless to support liability under Section 10(b) and Rule 10b-5. The district court also refused to reconsider its decision in response to plaintiffs' Rule 60(b) motion.

The Tenth Circuit Decision and Its Impact

The Tenth Circuit reiterated that plaintiffs' Rule 10b-5 claims, and in particular their allegations of scienter, were governed by the heightened pleading standard set forth by the Private Securities Litigation Reform Act of 1995 ("Reform Act"), 15 U.S.C. § 78u-4(b). The Court quoted the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322 (2007) [*see* blog article here], holding that in order for an inference of scienter to qualify as "strong" under the Reform Act, it must "be more than merely plausible or reasonable — it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."

The Tenth Circuit concluded that the district court did not err in determining that plaintiffs failed to meet this pleading standard. The operative complaint alleged that Grant Thornton knew of iMergent's revenue recognition policy and recklessly applied the "probable collectibility" standard under SOP 97-2 to the iMergent EPTA sales, departing enough from the standard of ordinary care to make Grant Thornton liable for securities fraud. The Tenth Circuit, however, recognized the existence of a continuing debate in the accounting community regarding the application of SOP 97-2. In light that debate, and the significant amount of judgment involved in applying SOP 97-2, the Tenth Circuit held that plaintiffs' allegations did not give rise to the requisite strong inference of recklessness.

The Tenth Circuit observed that other Circuits have adopted a heightened auditor-specific standard for recklessness in Rule 10b-5 cases. The Ninth Circuit articulated such a standard in *In re Worlds of Wonder Securities Litigation*, 35 F.3d 1407, 1426 (9th Cir. 1994), holding that an outside auditor acts recklessly only when "the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." The Tenth Circuit in *iMergent* held that it need not decide whether to adopt a heightened auditor-specific standard for recklessness, as the allegations in the complaint failed to give rise to a strong inference of any degree of recklessness. The Tenth Circuit compared the alleged conduct of Grant Thornton to that of a reasonable accountant confronted with the same factual scenario to determine the amount of departure, if any, from the standard of ordinary care.

Additionally, the Tenth Circuit rejected plaintiffs' arguments that the magnitude of the restatement weighs into an assessment of Grant Thornton's scienter. The Tenth Circuit pointed out that "the restatement would have been equally large had Grant Thornton acted in good faith, negligently, recklessly, or, for that matter, intentionally." Further, citing its own precedent, the Court held that a violation of GAAP only supports a claim of scienter "when coupled with evidence that the violations or irregularities are the result of the defendant's fraudulent intent to mislead investors." Such allegations were absent in this case.

The Tenth Circuit also denied plaintiffs' motion contending that orders from the PCAOB sanctioning against two Grant Thornton auditors involved in the iMergent audits constituted new evidence sufficient to support relief under Rule 60(b). Plaintiffs argued that the contents of these orders supported an inference of scienter by showing Grant Thornton knew that the EPTA collection rate was below 50%. The Tenth Circuit, however, found no abuse of discretion by the district court. The operative complaint alleged Grant Thornton's reckless interpretation of SOP 97-2 qualified it for liability, not that Grant Thornton recklessly conducted its audit by ignoring signs that collection rates were lower than iMergent's representations. As the PCAOB orders contained no new information about Grant Thornton's application of SOP 97-2, the orders failed to add any support to the deficient pleading. Moreover, the Tenth Circuit noted plaintiffs' inability to explain why they could not obtain the material discussed in the PCAOB orders earlier also worked against them in obtaining relief under Rule 60(b), especially considering iMergent's agreement to cooperate fully with the case after its settlement with plaintiffs.

This decision highlights the challenges plaintiffs face in meeting the high standard for pleading a Rule 10b-5 claim against independent auditors, even in the absence of a unified, auditor-specific standard for recklessness.

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