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SECURITIES FRAUD CRIMINAL LIABILITY AND ACCOUNTANTS' STANDARDS

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In recent public comments, Securities and Exchange Commission Chairman Harvey Pitt has focused on the Enron scandal to criticize the professional standards that govern accountants, particularly in the context of management fraud. According to Chairman Pitt, [p]resent-day accounting standards are cumbersome and offer far too detailed prescriptive requirements ... [which] encourage [] accountants ... to read accounting principles narrowly, to ascertain whether there is technical compliance with applicable accounting standards.¹ In advocating a broader set of accounting standards, Chairman Pitt highlighted a 40-year-old decision by Judge Henry Friendly in the Lybrand Ross criminal prosecution, **U.S. v. Simon**.² In that decision, the Second Circuit Court of Appeals rejected the defendant auditors' claim that criminal charges were foreclosed because the financial statements in question literally complied with generally accepted accounting principles. While Chairman Pitt's comments were aimed at a revision of the professional and regulatory mechanisms that govern an accountant's conduct, his comments are particularly poignant in light of the U.S. Department of Justice's ongoing efforts to investigate and prosecute Arthur Andersen and individual accountants who were involved in the Enron debacle.

While the DOJ is clearly focused at the moment on Andersen's alleged obstruction of justice through destruction of documents relating to the Enron audit, the question still hangs as to whether the government will attempt to impose criminal liability on the accounting firm (or individual Andersen or Enron accountants) for the Enron audits themselves, pursuant to securities, mail and wire fraud or even RICO laws. The class action plaintiffs in the civil litigation arising out of Enron's downfall have already alleged that Andersen and Enron engaged in securities fraud, and, as facts emerge through ongoing governmental investigations and prosecutions as well as the civil suits, Andersen and others may find themselves defending against criminal allegations of fraud.

The Accounting Standards

A substantive defense often raised in securities fraud prosecutions is a good faith defense, pursuant to which a defendant may rebut the government's necessary showing of willfulness by proving that the defendant had an honest belief in the truth of the allegedly misleading statements. In the context of a criminal prosecution of Andersen for securities fraud relating to the Enron audits, an essential component of the auditor's good faith defense will be that the audit under fire complied with the Generally Accepted Accounting Procedures and Generally Accepted Accounting Standards (GAAP and GAAS), promulgated by the American Institute of Certified Public Accountants (AICPA). In light of Chairman Pitt's view that current accounting standards do not sufficiently protect against management fraud and certain court decisions that have held that compliance with these standards does not necessarily afford a defense to allegations of fraud, the following question remains: to what extent does compliance with these professional standards insulate an auditor from liability for approving misleading financial statements?

SEC regulations stipulate that financial statements filed with the commission must be audited by an independent certified public accountant in accordance with the GAAS.³ The objective of that audit is an expression of an opinion on the fairness with which a company's financial statements present, in all material respects, its financial position, results of operations and cash flow in conformity with the GAAP.⁴ The GAAS are concerned not only with the auditor's professional qualities, but also with the judgment that the auditor exercises in performing an audit. These standards require that the audit be performed by someone with adequate training and proficiency, with an independent mental attitude and with due professional care. The GAAP include the standards that cover the preparation of financial statements and are used by an auditor to determine whether a business entity has prepared its financial statements in an acceptable manner - so that they can be effectively compared with a prior-year's statements and with the statements of other businesses.

While the GAAP demands compliance with certain esoteric rules and interpretations, these standards also leave ample room for professional judgment. Courts have acknowledged that the GAAP is not a rigid set of rules that define the precise and proper treatment of each and every conceivable business transaction. In the words of the Supreme Court, the GAAP is not a canonical set of rules that will ensure identical accounting treatment of identical transactions. The GAAP rather, tolerate a range of reasonable treatments, leaving the choice among alternatives to [the auditor].⁵

Securities Fraud Prosecutions

The vast majority of criminal prosecutions for alleged securities fraud are brought pursuant to the antifraud provisions of the Securities Act of 1933 (the 33 Act), 17(a) and the Securities Exchange Act of 1934 (the 34 Act), 10(b). Prosecutions under these statutes often also include related charges such as mail and wire fraud,⁶ RICO,⁷ False Statements Act violations⁸ and aiding and abetting. Section 24 of the 33 Act and 32(a) of the 34 Act, in turn, contain the general penalty provisions that authorize criminal securities prosecutions, including the imposition of criminal liability for willful violation of any provisions of the statutes, rules or regulations promulgated thereunder, and certain false or misleading filings pursuant to the statute.

The well-known antifraud provision of 10(b) of the 1934 Act and Rule 10b-5, promulgated thereunder, renders unlawful, in connection with the purchase or sale of any security, the employment of a device or scheme to defraud, the making of a material, untrue statement (affirmatively or by omission) or the engagement in any act, practice or course of business that would operate as a fraud or deceit.⁹ Accountants may be held liable under Rule 10b-5 for certifying false or misleading financial statements.¹⁰

Compliance With the GAAS and the GAAP as a Defense to Criminal Fraud Allegations. Only willful violations of the federal securities laws are criminal offenses. Thus, the government must prove scienter or an intent to defraud - that the defendants knew that the actionable representations were false or misleading or that such statements were made in reckless disregard of the truth.¹¹ In the context of an audit, the representations contained in a clean audit opinion can be the basis for a criminal fraud action in instances in which the defendant knew that he or she had no reasonable basis for the clean opinion or was reckless in forming such an opinion.¹² Thus, where an auditor has an honest belief as to the truthfulness of his or her opinion, was not reckless in the formation of this opinion and has a reasonable basis for this belief, the auditor should have a defense sufficient to rebut the prosecution's required proof of willfulness. Accountants have attempted to refute these elements of fraud by showing that they performed their audits in compliance with the GAAP and the GAAS. Given the over-arching requirements of the GAAP and the GAAS that an auditor act honestly, in good faith and with reasonable care in the performance of an audit, it could follow that an auditor's compliance with the GAAP and the GAAS would foreclose criminal liability for securities fraud in connection with an audit opinion. Various courts, however, have held that compliance with the GAAP and the GAAS does not, in all occasions, insulate an auditor from criminal liability.

'U.S. v. Simon'

A seminal case addressing auditor liability and compliance with the GAAP and the GAAS is **U.S. v. Simon**.¹³ The **Simon** defendants, present and former partners and associates of the accounting firm Lybrand, Ross Bros. & Montgomery, were convicted after a jury trial of filing false statements with the SEC, mail fraud and securities fraud - crimes arising out of their drawing up and certifying misleading financial statements of Continental Vending Machine Corp. (Continental). One issue on appeal was whether the government offered proof allowing a reasonable jury to find beyond a reasonable doubt that the defendants knew that the financial statements in question were materially misleading or false and that they deliberately sought to mislead.¹⁴

The defendants conceded that Continental and its president had engaged in a fraudulent scheme that was designed to enrich the company's president and CEO. However, at trial the defendants called numerous expert witnesses who testified that defendants' audit was not inconsistent with the GAAP or the GAAS because it made all the informative disclosures reasonably necessary for fair presentation of the financial position of Continental. Defendants then asked the court to instruct the jury that a defendant could be found guilty only if, pursuant to the GAAP, the financial statements as a whole did not fairly present the financial condition of Continental and then, only if the departure from the standards was due to willful disregard of those standards with knowledge of the falsity of the statements and an intent to deceive. The trial judge declined this instruction and charged the jury that the critical test was whether the financial statements as a whole fairly presented and accurately reported Continental's financial position and operations. If not, the judge charged, the basic issue became whether defendants acted in good faith. Proof of compliance with accounting standards

was charged to be evidence which may be very persuasive but not necessarily conclusive that defendants acted in good faith.¹⁵

On appeal, the Second Circuit Court of Appeals rejected the defendants' contention that the court's denial of their instruction and charge constituted reversible error. In considering the trial court's jury charge, the Second Circuit said that it thought the judge was right in refusing to make [compliance with accounting standards] so nearly a complete defense.... Such evidence may be highly persuasive, but it is not conclusive, and so the trial judge correctly charged.¹⁶ Addressing the requirements of the GAAP, the **Simon** court indicated that it could not fathom a system under which an accountant is under no duty to disclose what he knows when he has reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all the stockholders but for the private benefit of its president. The GAAP and the GAAS, the court concluded, instruct the accountant in the usual case where he has no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reason to believe that this basic assumption is false, he must extend his procedures to investigate his suspicions and, if confirmed, full disclosure must be the rule.¹⁷

'SEC v. Seaboard Corp.'

Like the **Simon** court, the Ninth Circuit Court of Appeals has focused on the GAAP and the GAAS as squarely relevant to the element of scienter. In **SEC v. Seaboard Corp.**,¹⁸ the defendant, accounting firm Ernst & Ernst, was alleged to have participated in a fraudulent scheme by certifying the financial statements contained in a prospectus issued in connection with a public offering of securities. The district court granted Ernst & Ernst's motion for summary judgment on the grounds that its certification complied with the GAAS.¹⁹ In reversing the grant of summary judgment, the Ninth Circuit considered whether defendant's affidavit in support of its motion, which stated that the audit had been performed in accordance with the GAAS, could refute allegations of scienter. According to the Court of Appeals, the GAAS and the GAAP do not provide protection from liability when the accountant fails to reveal material facts which he knows or which, but for a deliberate refusal to become informed, he should have known should be revealed. Pursuant to this standard, the defendant's compliance with accounting standards, even if accepted as true, did not necessarily imply that Ernst & Ernst did not know of the misrepresentations and omissions that occurred - making summary judgment inappropriate.²⁰

Implicit in these decisions of the Second and Ninth circuits is that an accountant has a duty to disclose or to refrain from certifying financial statements where such statements are misleading even though they comply with the strictures of the GAAP and the GAAS. Thus, an accountant with reason to suspect irregularities cannot rely on its compliance with professional standards to insulate it from potential liability for fraud committed by a client. Nevertheless, compliance with the GAAP and the GAAS are clearly a touchstone that decision-makers will use in order to assess an accountant's good faith in connection with performing an audit. Indeed, federal courts have split over the issue of whether a failure to comply with the GAAP may give rise, by itself, to an inference of fraud or scienter.²¹

However, in addressing auditor liability for securities fraud, it is crucial to remember that auditors are not guarantors of the accuracy of financial statements and that it is difficult, and often impossible, for an auditor to discover frauds that are perpetuated by management. This is especially so where the company's financial statements comply with the GAAP. Thus, where an auditor acts honestly, in good faith and with reasonable care in the discharge of his or her professional obligations, and does not possess actual knowledge that the audited financial statements contain materially misleading information, an auditor should have a defense to allegations of securities fraud.

1. Harvey L. Pitt, Remarks at the SEC Speaks Conference (Feb. 22, 2002) (text available at: <http://www.sec.gov/news/speech/spch540.htm>).

2. 425 F.2d 796 (2d Cir. 1969).

3. 17 C.F.R. 210.1-02(d).

4. 1 AICPA, Professional Standards, AU 110.01.

5. Thor Power Tool Co. v. C.I.R., 439 U.S. 522, 544 (1979); see also Shulala v. Guernsey Mem. Hosp., 514 U.S. 87, 101 (1995) (Far from being a single source of accounting rulebook, the GAAP encompasses the conventions, rules, and procedures that define accepted accounting practice at a particular point in time' ... the GAAP changes and, even at any one point, is often indeterminate. (citation omitted).

6. The elements of a charge of mail and wire fraud are a scheme and intent to defraud and the use of the mails or wires in furtherance of that scheme. 18 U.S.C. 1341, 1343.

7. 18 U.S.C. 371.

8. The false filing provision of the securities statute criminalizes the willful and knowing filing of a false statement with the SEC. 18 U.S.C. 1001.

9. 17 C.F.R. 240.10b-5.

10. See, e.g., *SEC v. Seaboard Corp*, 677 F.2d 1301 (9th Cir. 1982).

11. See *U.S. v. Boyer*, 694 F.2d 58, 59 (3d Cir. 1982).

12. See Arnold S. Jacobs, *5C Disclosure & Remedies Under the Securities Laws*, 12:116 (2001).

13. 425 F.2d 796 (2d Cir. 1969).

14. *Id.* at 805.

15. *Id.* at 805-06.

16. *Id.* at 806.

17. *Id.* at 807.

18. 677 F.2d 1301 (9th Cir. 1982).

19. *Seaboard*, 677 F.2d at 1304.

20. *Id.* at 1312.

21. Compare *In re Carter-Wallace, Inc. Sec. Litig.*, 150 F.3d 153, 157 (2d Cir. 1998) (holding that civil class action plaintiffs failed to state a claim solely by alleging a GAAP violation, but must have accompanying allegation with a statement of fraudulent intent); and *In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 627-28 (9th Cir. 1994) (affirming summary judgment for civil defendants where difference of opinion concerning revenue recognition issue under the GAAP foreclosed finding of scienter because reasonable accountants could have made the same decision under the same circumstances) with *Provenz v. Miller*, 102 F.3d 1478, 1490-91 (9th Cir. 1996) (denying defendants' motion for summary judgment where evidence of failure to comply with the GAAP was combined with insider trading), cert. denied, 522 U.S. 808 (1997).