Public Employees' Retirement Association of Colorado v. Deloitte & Touche, LLP: Dismissal of 10b(5) Claims Affirmed Where Auditor's Investigation Negates Finding Scienter

In *Public Employees' Retirement Association of Colorado v. Deloitte & Touche, LLP*,[1] the Fourth Circuit added new precedent to the line of cases interpreting a plaintiff's burden of pleading scienter under the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*[2] The court found that the plaintiffs failed to allege with sufficient particularity that an auditor had the necessary scienter for a claim under Securities Exchange Act § 10(b) where the auditor had taken steps to uncover two separate accounting frauds perpetrated by its clients.[3] While the plaintiffs alleged that the auditor, Deloitte & Touche, LLP,[4] should have uncovered the frauds earlier, the Fourth Circuit found that the Deloitte's investigation of its clients' characterization of two different types of transactions was sufficient to negate "any competing inference that [Deloitte] knowingly or recklessly perpetrated a fraud on [its clients'] investors."[5]

I. Facts

The case arose from the accounting treatment of two types of transactions by Royal Ahold, N.V. ("Ahold"), and U.S. Foodservice, Inc. ("USF"), a Dutch company and its United States subsidiary, respectively. The first type of transaction was a series of joint ventures between Ahold and supermarket operators in Europe and Latin America. While Ahold held a 49% or 50% stake in the joint ventures, for accounting purposes it "consolidated" all of the revenues from the joint ventures as its own revenue on its balance sheet, as opposed to only the revenues proportional to its stake. However, prior to entering the joint venture agreements Deloitte had informed Ahold that Dutch and U.S. GAAP required that it could not consolidate the joint venture revenues unless it "controlled" the joint ventures, either by holding a majority voting interest or by contract.

Initially, although the agreements did not specify that Ahold controlled the joint ventures, Ahold represented to Deloitte that it in fact did control them. Deloitte subsequently requested evidence from Ahold's CFO that it controlled the joint ventures. Between 1999 and 2002, Ahold obtained written agreements ("control letters") signed by the counterparties to the joint ventures stating that Ahold's position would prevail if there was a disagreement between the parties about any matter pertaining to the joint venture. Deloitte later learned that each of Ahold's partners had sent "side letters" contradicting the control letters. Consequently, Deloitte informed Ahold that it did not have the requisite control over the joint ventures to consolidate the revenues.

The second type of transaction at issue were rebates from USF's vendors known as "promotional allowances" paid to USF in exchange for its promotion of the vendors' products. Prior to Ahold's acquisition of USF in 2000, Deloitte had participated in the due diligence leading up to the deal and informed Ahold that the system USF used to account for promotional allowance income was prone to manipulation and could result in fraud. Following Ahold's acquisition of USF, Deloitte served as USF's auditor and performed an initial review of

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1 *Public Employees' Retirement Association of Colorado v. Deloitte & Touche, LLP*, No. 07-1704, _ F.3d _, 2009 WL 19134, at *1 (4th Cir. Jan. 5, 2009) (hereinafter, "*Deloitte*"), available at http://pacer.ca4.uscourts.gov/opinion.pdf/071704.P.pdf.

2 *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007) (holding that under the Private Securities Litigation Reform Act ("PSLRA") plaintiffs must plead facts alleging a strong inference that defendants acted with scienter).

3 *Deloitte*, 2009 WL 19134, at *20.

4 Two distinct Deloitte entities were defendants in the case. Herein they are both referred to as "Deloitte."

5 *Deloitte*, 2009 WL 19134, at *3.

its balance sheet. The initial review uncovered that a division of USF had been fraudulently accounting for promotional allowance income.

Subsequently, during a separate internal audit of USF by Deloitte, one goal of which was to determine whether USF was accurately accounting for promotional allowance income, Deloitte encountered resistance from USF management when it sought documents from vendors and interviews with USF managers. A 2003 external audit by Deloitte concluded that USF had inflated its promotional allowance income for 2002. Ultimately, in February 2003, Ahold announced that it had overstated its 2001 and 2002 earnings by $500 million and later went on to restate its earnings by a further $24.8 billion in revenues and about $1.1 billion in net income. Numerous class action complaints were promptly filed against Ahold, USF and Deloitte and consolidated in the United States District Court for the District of Maryland.

II. District Court Opinion

The district court granted Deloitte's motion to dismiss the plaintiffs' allegations that it violated § 10(b) and Rule10b-5 of the Securities Exchange Act because the complaint failed to plead facts alleging a strong inference of scienter.[6] Following a settlement with Ahold the plaintiffs sought to file a second amended class action complaint against Deloitte. The district court held that another complaint would be futile and denied the motion because plaintiffs' new complaint still failed to meet the heightened pleading standard imposed by the PSLRA. The district court held that because Deloitte required Ahold to provide confirmation of its representations regarding the joint ventures, and because Ahold found it necessary to conceal the side letters, the inference to be drawn was that Deloitte did not participate in the fraud or behave recklessly. Regarding the promotional allowances, the district court observed that "despite having been repeatedly lied to by senior USF officers and employee [sic], [Deloitte] eventually discovered the fraudulent scheme . . . as a result of . . . testing management's representations about the promotional allowances at USF." Thus, the district court concluded that plaintiffs failed to demonstrate that Deloitte's audit of USF was ineffectual to the point of recklessness.

III. Fourth Circuit Opinion

The Fourth Circuit began by recounting the history of the PSLRA and the case law that developed regarding the standard for pleading scienter.[7] The court then repeated the analysis set forth by the Supreme Court in *Tellabs*, which requires consideration of whether all of the alleged facts taken together give rise to a strong inference of scienter, and then whether that inference is cogent and compelling when compared to plausible opposing inferences.[8] In other words, "[h]aving drawn all plausible inferences, [the Fourth Circuit would] reverse the district court only if [it found] the inference that [Deloitte] acted with scienter 'at least as compelling' as the inference that the defendants lacked the required mental state."[9]

The Court of Appeals observed that its precedent permitted a finding of scienter based on either recklessness or intentional conduct, and that a mere showing of negligent conduct by a defendant was insufficient and that the standard for recklessness was "an extreme departure from the standard of care [that presented] a danger of misleading the plaintiff . . . [which] was either known to the defendant or so obvious that the defendant

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6 *In re Royal Ahold N.V. Securities & ERISA Litig.*, 351 F. Supp. 2d 334, 385-96 (D. Md. 2004).

7 *Deloitte*, 2009 WL 19134, at *10-13.

8 *Id.* at *13.

9 *Id.* at *14.

must have been aware of it."[10] Thus, to reverse the district court, the Court of Appeals had to draw a strong inference that Deloitte "either knowingly or recklessly defrauded investors by issuing false audit opinions in violation of Rule 10b-5(b) or 10b-5(a) and (c)."[11] To be liable under § 10(b), Deloitte must have done more than "assist another in violating § 10(b)."[12]

The court first addressed the joint venture fraud and the plaintiffs' contention that Deloitte was complicit in the fraud because it accepted the letters from Ahold's partners as sufficient evidence of Ahold's control. The court held that "[t]he most plausible inference that one can draw from the fact that Ahold concealed the side letters from [Deloitte] is that [Deloitte] was uninvolved in the fraud."[13] Thus, the court concluded that Deloitte's conduct with regard to the joint ventures lead to a strong inference that Deloitte properly discharged its responsibilities and had been hindered in doing so by Ahold. Moreover, the court stated that it was not sufficient for the plaintiffs to allege that Deloitte should or could have done more to uncover the fraud, but that they were instead required to plead that Deloitte was either reckless or actually complicit in the fraud.

Regarding the promotional allowance income, the plaintiffs argued that Deloitte was complicit in the fraud because "it ignored several 'red flags,'" such as the lack of proper accounting for promotional allowance income and management's refusal to cooperate when Deloitte requested documents. However, the court noted that Deloitte had raised the issue of poor internal controls with Ahold and that it also attempted to verify the promotional allowance income numbers USF reported by contacting the third-party vendors. Thus, the court concluded that "the strongest inference one can draw from the evidence is that the fraud initially went undetected because of USF's collusion with the vendors, not because of wrongdoing by Deloitte."[14]

IV. Comments

While accountants are not immune from liability where a strong inference of scienter can be drawn, it would be "counter to the purposes of the PSLRA" to hold an auditor liable where the client conspired with others to hide from its auditor the truth about its finances.[15]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

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10 *Id.* at *15.

11 *Id.*

12 *Id.* at *15-16 (citing *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008)).

13 *Id.*

14 *Id.* at *19.

15 *Id.*