

Securities Regulation Daily Wrap Up, ACCOUNTING AND AUDITING—S.D.N.Y.: Fraud claims dismissed against Deloitte and its Shanghai affiliate, (Apr. 3, 2015)

By R. Jason Howard, J.D.

The Southern District of New York has agreed with the arguments made by Shanghai-based independent auditor, Deloitte Touche Tohmatsu CPA, Ltd. (DTTC) in dismissing with prejudice a securities fraud action brought by a group of investors who purchased stock in ChinaCast Education Corporation, Inc., an educational services company in the People's Republic of China (PRC) ([*Special Situations Fund III QP, L.P. v. Deloitte Touche Tohmatsu CPA, Ltd.*](#), March 31, 2015, Ramos, E.).

Background. In an earlier complaint, the plaintiffs alleged that if DTTC had performed an audit that complied with U.S. Public Accounting Oversight Board (PCAOB) standards and Generally Accepted Accounting Principles (GAAP), it would have ascertained evidence of fraud. The plaintiffs outlined a series of “red flags” that Deloitte had failed to uncover and expose.

The court explained that plaintiffs’ allegations were insufficient to establish scienter, a crucial element of their claims, which requires particularized allegations demonstrating fraudulent intent and not merely negligent performance or non-compliance with industry standards. Taken collectively, the court concluded, “Plaintiffs’ red flags and alleged accounting violations...failed to tip the scale from negligence to recklessness.”

Motion for leave. In the plaintiffs’ motion for leave to amend, they asserted that the second amended complaint (SAC) would cure the deficiencies of the prior complaint by adding new, detailed allegations demonstrating that DTTC and Deloitte U.S. were aware of many aspects of the fraud, that DTTC facilitated some of ChinaCast’s fraudulent accounting decisions, and that Deloitte deliberately disregarded numerous red flags that no reasonable auditor would have ignored.

Scienter. The court reviewed the new allegations in the SAC, but ultimately determined that the SAC did not cure the deficiencies from the first amended complaint (FAC). The court explained that in half of the new assertions made, the plaintiffs attempted to convert allegations of negligent omissions into allegations of deliberate or willful repudiation of duty saying that terms such as “deliberately” or “willfully” do not prove scienter. The plaintiffs’ conclusory allegations that DTTC “must have taken” certain steps or decided, for nefarious reasons, not to take other steps, fill the factual void, according to the court.

As to the SAC’s other allegations, the court said that the plaintiffs endeavored to state claims using “facts, communications, or events that are just as likely to undercut as to support an inference of scienter, or that provide no insight at all into the Deloitte defendants’ state of mind” and that, in retrospect, certain actions or statements may be interpreted or characterized as demonstrating awareness of fraud, but that “fraud by hindsight” is not a cognizable theory of relief. “[F]raud is always obvious in retrospect, but it is not reckless to lack clairvoyance,” the court advised.

Misstatements or omissions of material fact. The court had previously held that the FAC, in addition to not establishing scienter, did not sufficiently allege a material misstatement or omission. The court said that the new allegations did not establish that DTTC subjectively knew its audit opinions to be false, and that the plaintiffs still could not allege that DTTC “either did not in fact hold its opinions or knew that it had no reasonable basis for them.”

Control person liability. The court explained that, as with the FAC, the plaintiffs’ failure to establish a primary 10(b) violation precluded a claim under Section 20(a) against Deloitte U.S. The court said that even if the plaintiffs had established a primary violation, the SAC, like the FAC, did not state with particularity any facts that would enable the court to conclude that Deloitte U.S. culpably participated in any fraudulent activity.

False or misleading statements. Plaintiffs did not need to allege scienter in their Section 18 claim, but they needed to allege actual reliance on specific statements in covered Exchange Act filings. In the FAC, the plaintiffs failed to allege and could not causally link

specific statements in specific audit opinions to purchases of ChinaCast stock. Similarly, in the SAC, the plaintiffs stated that certain of the Section 18 plaintiffs made stock purchase decisions in reliance on the company's SEC filings, but again they fell short of alleging the subjective falsity of DTTC's opinions, which would be the only possible basis for Section 18 liability.

Common law fraud. In New York, common law fraud requires a plaintiff to allege that: (1) the defendant made a representation as to a material fact; (2) such representation was false; (3) the defendant intended to deceive plaintiff; (4) the plaintiff believed and justifiably relied upon the statement and was induced by it to engage in a certain course of conduct; and (5) as a result of such reliance, the plaintiff sustained pecuniary loss, in addition to pleading scienter. Again, the court concluded that plaintiffs did not plead facts giving rise to a strong inference of scienter with regard to either DTTC or Deloitte U.S.

Conclusion. The plaintiffs' motion for leave to file a second amended complaint was denied and the proposed claims against the Deloitte defendants were dismissed with prejudice.

The case is [No. 13 Civ. 1094 \(ER\)](#).

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Companies: Special Situations Fund III QP, L.P.; Special Situations Cayman Fund, L.P.; Columbia Pacific Opportunity Fund, L.P.; Fir Tree Value Master Fund, L.P.; Fir Tree Capital Opportunity Master Fund, L.P.; Deloitte Touche Tohmatsu CPA, Ltd.; Deloitte & Touche L.L.P.

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