

Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION— S.D.N.Y.: Shareholders unable to show that auditors' failure to discover fraudulent asset transfer is actionable, (Jun. 19, 2014)

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By Amanda Maine, J.D.

A federal court dismissed false statement and fraud claims against auditors of a company whose chairman transferred its assets to himself without disclosing the transfer. The plaintiffs' proffered expert lacked the qualifications to opine on whether the auditors had conducted the audits in accordance with PCAOB standards. The plaintiffs were also unable to show that the auditors acted egregiously or that they had actual knowledge of the asset transfer (*In the Matter of Puda Coal Securities Inc. Litigation*, June 17, 2014, Forrest, K.).

Background. In September 2009, the chairman of Chinese coal company Puda Coal, Inc., Ming Zhao, and his brother, Yao Zhao, arranged to transfer Puda's 90 percent interest in Shanxi Puda Coal Group to Ming Zhao, which left Puda a shell corporation with neither operations nor any source of revenue. Puda's 2009 and 2010 financial statements filed with the SEC indicated that Puda still maintained a 90 percent interest in Shanxi, rendering them materially misstated and not prepared in accordance with GAAP. The stripping of Puda's assets by the Zhaos was first brought to light in an April 2011 report published by Alfred Little. Following this disclosure, Puda's shares declined 34 percent and the SEC ultimately ended up halting the trading in Puda's shares entirely. Shareholders filed numerous lawsuits against several individuals and entities, including Puda's auditors.

Moore Stephens Hong Kong (MSHK) conducted the audits of Puda's 2009 and 2010 financial statements and Moore Stevens P.C. (MSPC) performed an Appendix K review. As a non-U.S. firm, Moore Stephens was required to have "Appendix K" review procedures performed on its audits of U.S.-registered companies. MSHK personnel spent substantial time at Shanxi in connection with their work to confirm that Puda owned 90 percent of the company and ultimately issued a clean audit opinion on the 2009 and 2010 financial statements. In July 2011, MSHK resigned as Puda's auditor and announced that its 2009 and 2010 audit opinions could no longer be relied upon. Shareholders alleged claims against both auditors under Securities Act Sec. 11 and Exchange Act Sec. 10(b).

Experts. The defendants moved to exclude the plaintiffs' sole auditing expert, Anita C.M. Hou, on the basis that she lacked the required expertise. The court noted that the plaintiffs proffered Hou as an expert in Hong Kong and/or People's Republic of China (PRC) generally accepted auditing standards and had argued that "similar concepts and principles are adopted in the auditing standards in the U.S., PRC, and Hong Kong." The court pointed out that the relevant standard of care against which it must measure the auditor's conduct is that of an auditor conducting an audit under PCAOB standards. Hou has never conducted an audit under these standards and had conceded that she lacks qualifications to opine in this area, the court stated. Without the relevant expertise, Hou's opinions that assert the auditors performed inadequately are unreliable, the court found, and granted MSHK's motions to exclude Hou's expert report, testimony and declarations.

The plaintiffs moved to exclude two of the auditors' proffered experts on the grounds that they are "case-in-chief" experts and not rebuttal experts, and as such should have been disclosed to the parties earlier. The court was unconvinced with the plaintiffs' argument that because the plaintiffs withdrew their initial expert, the auditors' rebuttal experts should be treated as case-in-chief experts. The plaintiffs "cannot withdraw their expert and expect that they can thereby achieve a secondary benefit of controlling the Auditors' expert choices," the court observed. The court also found that a third expert proffered by the auditors was qualified to offer his opinion and that his testimony would be helpful to the trier of fact, and denied the plaintiffs' motions to exclude the auditors' experts.

Scienter. The plaintiffs' 10(b) claim alleged that the auditors' conduct fell "egregiously short" of applicable standards and that this met 10(b)'s scienter requirement. However, the court pointed out that it is "crystal clear" that the standards of care against which the auditors' conduct must be measured are PCAOB standards, and,

with the exclusion of Hou and her testimony, the plaintiffs present no admissible evidence as to what PCAOB standards with which the auditors failed to comply.

Subjective falsity. Section 10 and 11 claims regarding opinion statements require plaintiffs to show that the defendants did not honestly believe the statements when they made them; i.e., that the statements were both objectively and subjectively false. The court explained that the plaintiffs had not presented any evidence that the auditors knew that the Zhao brothers had transferred Shanxi to themselves in 2009. Without a triable issue as to subjective falsity, the court said it was necessary to dismiss both the Sec. 10 and Sec. 11 claims.

The case is No.11-cv-2598.

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Companies: Hotel Ventures; Puda Coal, Inc.; Moore Stephens Hong Kong; Moore Stephens, PC

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