In re Advanced Battery Technologies, Inc.: How Independent Auditors of Chinese Reverse Merger Companies Avoid Liability in Securities Fraud Litigation

I. OVERVIEW

Advanced Battery Technologies (ABAT) is a Delaware corporation, which was founded and mainly operates in China.[1] Its principal business is designing, producing, and selling rechargeable polymer lithium-ion batteries for use in consumer products, such as portable computers and electric vehicles.[2] In 2004, ABAT listed its stock on a U.S. exchange via a transaction commonly known as a "reverse merger," meaning it could be "acquired" by a publicly traded shell corporation in the United States.[3] Once listed, ABAT was required to file audited financial statements with the Securities and Exchange Commission (SEC).[4] Bagell, Josephs, Levine & Co. and its successor, Friedman LLP (together, Bagell Josephs) served as ABAT's outside auditor from 2006 through December 14, 2010.[5] EFP Rotenberg, LLP (EFP) started auditing ABAT's financial statements on December 14, 2010.[6] Between May 15, 2007, and March 29, 2011, ABAT reported "increasing revenues, gross profits and net income" in its SEC filings.[7] Meanwhile, ABAT filed financial

1. *In re* Advanced Battery Tech., Inc. (*In re Advanced Battery I*), 781 F.3d 638, 642 (2d Cir. 2015).
2. *Id.*
3. *Id.*
4. *Id.*
5. *Id.* at 643.
6. *Id.*
7. *Id.* at 642.

statements with China's State Administration of Industry and Commerce (AIC), a regulatory agency that reviews Chinese companies' financial statements annually.[8] ABAT's AIC filings, however, contradicted the figures reported in its SEC filings.[9] Particularly, ABAT reported losses to the AIC from 2007 to 2009.[10] In March 2011, third-party publications discussed ABAT's significantly lower revenue and profit in its AIC filings and other fraudulent conduct.[11] On the day the reports were posted, the price of ABAT's shares plummeted nearly 48%.[12]

Purchasers of ABAT shares during this period filed securities fraud actions against ABAT and certain executives, as well as ABAT's external auditors, Bagell Josephs, and EFP.[13] The defendants moved to dismiss the complaints, but the United States District Court for the Southern District of New York only granted Bagell Josephs' and EFP's (collectively, the Auditor Defendants) motions.[14] With respect to the Auditor Defendants, the district court held that the plaintiffs failed to adequately plead scienter, "a mental state embracing intent to deceive, manipulate, or defraud,"[15] as required by the Private Securities Litigation Reform Act of 1995 (PSLRA).[16] The plaintiffs moved for leave to file an amended complaint (Proposed Complaint).[17] The district court denied the motion and held that the new allegations failed to cure the deficiencies identified in the initial complaint.[18] The plaintiffs appealed the district court's order.[19] The United States Court of Appeals for the Second Circuit affirmed the district court's opinion and *held* that the Proposed Complaint did not adequately plead facts giving rise to a strong inference

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8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.* at 643. Other fraudulent conduct includes: (1) ABAT acquired Shenzhen Zhongqiang New Energy Science & Technology Co., Ltd. ("Shenzhen") in December 2010 for $20 million but failed to disclose that its Chairman and Chief Executive Officer owned Shenzhen and had paid a mere $1 million for the company in 2008; (2) ABAT identified Heilongjiang Zhongqiang Power–Tech Co., Ltd. as a wholly owned subsidiary in its SEC filings for 2007 and 2008, but it was revealed in 2009 SEC filing that ZQPT was actually owned by ABAT's Chairman and Chief Executive Officer and other investors. *See id.* at 642-43.
12. *Id.* at 643.
13. *Id.*
14. *Id.*
15. *Id.* at 644.
16. *Id.* at 641.
17. *Id.* at 644.
18. *Id.* at 641.
19. *Id.*

of scienter as to the Auditor Defendants. *In re Advanced Battery Technologies, Inc.*, 781 F.3d 638, 641 (2d Cir. 2015).

II. BACKGROUND

A. Chinese Reverse Mergers (CRM)

The SEC defines a reverse merger as one in which a private company obtains access to U.S. capital markets without effecting an initial public offering (IPO) or filing a registration statement with the SEC, but rather gains access through "acquisition" by an existing public shell company.[20] The shell company[21] has nominal operations and assets, but its shares are publicly held and registered under the Securities Exchange Act of 1934.[22] After the transaction, the private company's shareholders gain a controlling interest in the public shell company, and, in essence, the private company becomes the SEC reporting entity with access to U.S. capital markets.[23] As a publicly traded company, the surviving entity is required to file audited financial statements with the SEC, and the auditors of those financial statements are required to be registered with the Public Company Accounting Oversight Board (PCAOB).[24]

The SEC has taken tentative steps to protect investors from the perceived risks of reverse mergers.[25] In 2005, the SEC adopted new rules governing reverse mergers, which require the surviving entity to file an

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20. *See* SEC. EXCH. COMM'N, INVESTOR BULLETIN: REVERSE MERGERS 1 (June 2011), https://www.sec.gov/investor/alerts/reversemergers.pdf.

21. The shell company could be: (1) a formerly operating public company that has ceased operations and liquidated its assets for some reason; or (2) formed specifically for the purpose of the reverse merger. William K. Sjostrom, Jr., *The Truth About Reverse Mergers*, 2 ENTREPRENEURIAL BUS. L.J. 743, 744 (2008).

22. *See* 17 C.F.R. § 230.405 (2015).

23. CORNERSTONE RESEARCH, INVESTIGATIONS AND LITIGATION RELATED TO REVERSE MERGER COMPANIES—FINANCIAL, ECONOMIC, AND ACCOUNTING QUESTIONS 2 (2011) [hereinafter CORNERSTONE RESEARCH, INVESTIGATIONS & LITIGATION].

24. PUB. CO. ACCOUNTING OVERSIGHT BD., ACTIVITY SUMMARY AND AUDIT Implications for Reverse Mergers Involving Companies from the China Region: June 1, 2007 to March 31, 2010, at 6 (Mar. 14, 2011), http://pcaobus.org/research/documents/chinese_reverse_merger_research_note.pdf. The Public Company Accounting Oversight Board [PCAOB] is a nonprofit corporation which was established by the Sarbanes-Oxley Act of 2002, and overseen by the SEC. Its primary functions are setting accounting principles, supervising audits of public companies, and inspecting auditing firms on an annual or triennial basis. Katherine T. Zuber, *Breaking Down a Great Wall: Chinese Reverse Mergers and Regulatory Efforts To Increase Accounting Transparency*, 102 Geo. L.J. 1307, 1310, 1321 (2014).

25. *See* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Exchange Act Release Nos. 33,8400, 34,49424, 69 Fed. Reg. 15,554 (Mar. 25, 2004).

amended, more detailed Form 8-K within four business days of the transaction (previously there was a seventy-day window) to provide the same information that would be required if the company had been registering a class of securities.[26] Audited financial information is required as part of the Form 8-K, as well.[27]

Compared to an IPO, a reverse merger allows the company to avoid potentially prohibitive processes, i.e., filing and review of a registration statement and prospectus delivery,[28] and can provide foreign companies with more economical and efficient access to U.S. capital markets.[29] Although reverse merger companies must promptly disclose almost the same amount of information that they would have had to disclose during the IPO process,[30] companies would not be subjected to strict liability under section 11 of the Securities Act of 1933.[31] A reverse merger company only faces liability for misstatements in its disclosures upon a showing of scienter under Rule 10b-5.[32]

A significant number of Chinese companies choose to list their stocks on the U.S. stock exchanges through reverse mergers.[33] Between January 2007 and March 2010, an estimated 150 Chinese companies gained access to U.S. capital markets via reverse mergers.[34] In contrast, only fifty-six Chinese companies conducted IPOs.[35] The advantages of reverse mergers and American investors' enthusiasm for Chinese

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26. *See id.*; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Exchange Act Nos. 33,8587, 34,52038, 70 Fed. Reg. 42,234 (July 21, 2015).

27. Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234.

28. Zuber, *supra* note 24, at 1310.

29. Paul R. Bessette et al., *Securities Litigation in 2011 by the Numbers, and a Look Behind the Risk in Securities Cases Against U.S. Listed Chinese Companies*, 59 ADVOC. TEX. 40, 40 (2012).

30. Comparing SEC Form 8-K with SEC Form S-1. *See* SEC, Current Report (Form 8-K), https://www.sec.gov/about/forms/form8-k.pdf (last visited Apr. 19, 2016); SEC, Registration Statement Under the Securities Act of 1993 (Form S-1), https://www.sec.gov/about/forms/forms-1.pdf (last visited Apr. 19, 2016).

31. 15 U.S.C. § 77k (2012). A section 11 plaintiff does not need to establish a defendant's scienter, or even negligence, to prove his case. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983). However, all defendants, except the issuer, may defend themselves by establishing that they had reasonable grounds to believe and did believe in the truth of the registration statement. *See* 15 U.S.C. § 77k(b)(3).

32. *See* 17 C.F.R. § 240.10b-5 (2015); 15 U.S.C. § 78u-4(b)(2) (2012).

33. CORNERSTONE RESEARCH, INVESTIGATIONS & LITIGATION, *supra* note 23.

34. *Id.*

35. *Id.*

investment opportunities in response to the growing Chinese economy has contributed to the increased popularity.[36]

The trend of reverse mergers involving Chinese companies has been scrutinized by the SEC and the PCAOB.[37] In the summer of 2010, the SEC launched investigations into the accounting practices of several CRM companies.[38] The investigations resulted in the suspension of trading, halting of trading, or delisting of the securities of companies for problems such as failure to comply with SEC requirements and failing to demonstrate compliance with initial listing standards.[39] Additionally, the SEC issued an investor warning bulletin regarding the potential risk of investing in a reverse merger company.[40] Around the same time, the PCAOB issued an audit practice alert and a research note regarding the auditing practices of these companies.[41] Shareholders quickly responded by filing securities fraud actions against these companies, their directors, and outside auditors under Rule 10b-5.[42] From 2010 to 2011, there were forty-two class actions filed against CRM companies.[43] Most of these cases alleged misrepresentations in financial documents and noncompliance with Generally Accepted Accounting Principles (GAAP).[44]

B. Auditor Liability Under Rule 10b-5 and Scienter

Rule 10b-5 is a general prohibition against fraudulent behavior related to securities.[45] Section 10(b) of the Exchange Act entitles private plaintiffs an implied right of action against corporate filers and their auditors.[46] The SEC issued Rule 10b-5 pursuant to section 10(b) specifically making it illegal to: (1) "employ any device, scheme, or artifice to defraud," (2) "make any untrue statement of a material fact or

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36. Zuber, *supra* note 24, at 1308.
37. *See* CORNERSTONE RESEARCH, INVESTIGATIONS & LITIGATION, *supra* note 23.
38. *Id.*
39. *Id.*
40. *Id.*
41. *Id.*
42. *Id.* at 1.
43. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2011 YEAR IN REVIEW 6 (2012) [hereinafter CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS].
44. *Id.* GAAP consists of accounting conventions used to create consistent, comparable financial information across organizations. *See* James F. Strother, *The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards*, 28 VAND. L. REV. 201, 201-07 (1975).
45. Eric L. Talley, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 COLUM. L. REV. 1641, 1652 (2006).
46. *See* 15 U.S.C. § 78j (2012).

to omit to state a material fact necessary in order to make the statements made . . . not misleading," or (3) "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person" related to "the purchase or sale of any security."[47]

Since the United States Supreme Court's 1976 decision in *Ernst & Ernst v. Hochfelder*,[48] to establish liability under Rule 10b-5, a private plaintiff must prove that the defendant acted with "scienter,"[49] which is "a mental state embracing intent to deceive, manipulate, or defraud."[50] The Court held that merely negligent misstatements would not be sufficient.[51] In 1995, Congress passed the PSLRA, which requires that private plaintiffs, in addition to satisfying the specificity requirements of Rule 9(b) of the Federal Rules of Civil Procedure,[52] to "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind."[53] Congress, however, did not define the key term "strong inference."[54] In the 2007 Supreme Court case *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, "strong inference" was clearly articulated for the first time.[55] To determine whether the facts the plaintiffs alleged raise a strong inference of defendant's scienter, "a court must consider plausible, nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff."[56] The inference of a defendant's scienter "need not be irrefutable," but cannot be merely "reasonable" or "permissible," rather, it should be "cogent and at least as compelling as any opposing inference."[57] In applying the strong inference standard, federal appellate courts have differed as to whether allegations of motive and opportunity to commit fraud satisfy the standard.[58] The Second Circuit and the district courts within the Second Circuit generally agree that to meet the standard, plaintiffs must allege facts showing either: (1) "that defendants had both motive and opportunity" to commit fraud,

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47. 17 C.F.R. § 240.10b-5 (2015).
48. 425 U.S. 185 (1976).
49. *Id.* at 193.
50. *Id.*
51. *Id.* at 201.
52. FED. R. CIV. P. 9 (requiring particularized pleading regarding alleged misstatements, i.e., what the alleged misstatement is and why it was false when made).
53. 15 U.S.C. § 78u-4(b)(2) (2012).
54. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).
55. *Id.* at 314.
56. *Id.* at 324.
57. *Id.*
58. *See* Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097, 1158-59 (2007).

or (2) "strong circumstantial evidence of conscious misbehavior or recklessness."[59]

In a lawsuit against independent auditors, this pleading standard can be difficult to meet prior to discovery,[60] which plaintiffs would not be entitled to at the pleading stage under PSLRA.[61] For the first category, "motive and opportunity" refer to the means and possibility to achieve "concrete benefits" by the false statements.[62] It should be noted that, however, courts generally do not recognize "mere receipt of compensation and the maintenance of a profitable professional business relationship" as sufficient for purposes of pleading scienter.[63] Plaintiffs often have difficulty alleging an independent auditing firm's motive to commit fraud, because those firms hardly have economic incentive to participate in the clients' fraud[64] and also value their reputation for professional integrity.[65] The only real motive for the firms might be to maintain a positive relationship with the clients.[66]

When plaintiffs are not able to satisfy the motive and opportunity standard, they may seek to plead scienter under the recklessness theory.[67] To satisfy the pleading standard of recklessness, as the Second Circuit pointed out in *Kalnit v. Eichler*, plaintiffs could plead by "identifying circumstances indicating conscious behavior by the defendant," but the "strength of the circumstantial allegations" must be greater than the "motive and opportunity" situation.[68] The Second Circuit interpreted the recklessness standard in *Rothman v. Gregor*[69] as requiring plaintiffs to show that the defendant's alleged conduct is at the least "highly unreasonable" and which represents "an extreme departure from the standards of ordinary care."[70] The court also emphasized that the degree of recklessness must "approximate an actual intent to aid in the fraud being perpetrated by the audited company."[71] The Second Circuit further

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59. *See id.* at 1160.
60. Talley, *supra* note 45, at 1653-54.
61. 15 U.S.C § 78u-4(b) (2012).
62. Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1130 (2d Cir. 1994).
63. Zucker v. Sasaki, 963 F. Supp. 301, 308 (S.D.N.Y. 1997).
64. *See* Reiger v. Price Waterhouse Coopers LLP, 117 F. Supp. 2d 1003, 1007-08 (S.D. Cal. 2000).
65. *See* Amy Shapiro, *Who Pays the Auditor Calls the Tune?: Auditing Regulation and Clients' Incentives*, 35 SETON HALL L. REV. 1029, 1039 (2005).
66. *See id.* at 1040.
67. Mark, *supra* note 58, at 1205-07.
68. 204 F.3d 131, 142 (2d Cir. 2001).
69. 220 F.3d 81 (2d Cir. 2000).
70. *Id.* at 98.
71. *Id.*

illustrated such standard in *Gould v. Winstar Commc'ns, Inc.*[72] In this case, though the defendant spent a lot of time auditing and reviewing large number of documents, he "repeatedly failed to scrutinize serious signs of fraud."[73] The court found that "a jury reasonably could determine that the audit was so deficient," and the plaintiff sufficiently plead scienter under the recklessness standard.[74]

It is well established in the Second Circuit, specifically in *Chill v. General Elec. Co.*[75] and *Novak v. Kasaks*,[76] that mere GAAP violations alone, without a showing of the defendant auditor's fraudulent intent, are not sufficient to state a Rule 10b-5 claim.[77] The court also held in *Chill* that even though the company's profits largely and suddenly increased and the defendant failed to further investigate, such conduct does not constitute recklessness.[78] Moreover, the court held in *S. Cherry St., LLC v. Hennessee Grp. LLC*[79] that a defendant's non-performance of promised due diligence could not raise a "cogent or compelling suggestion" of its scienter.[80]

C. Litigation Against CRM Companies' Independent Auditors

Plaintiffs face a variety of hurdles in suing CRM companies and their officers and directors, such as service of an officer or director who resides in China and usage of Chinese documents.[81] Because U.S. firms audited a high percentage of CRM companies, plaintiffs generally sue the auditors as well, without needing to worry about the issues stated above.[82] Despite this advantage, there is a growing trend of courts rejecting securities fraud actions filed against independent auditors in the context of CRM, mostly due to a failure to sufficiently plead scienter.[83]

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72. 692 F.3d 148 (2d Cir. 2012).
73. *Id.* at 160.
74. *Id.*
75. 101 F.3d 263 (2d Cir. 1996).
76. 216 F.3d 300 (2d Cir. 2000).
77. *Chill*, 101 F.3d at 270; *Novak*, 216 F.3d at 309.
78. *See Chill*, 101 F.3d at 270.
79. 573 F.3d 98 (2d Cir. 2009).
80. *Id.* at 113.
81. *See* A. Robert Pietrzak et al., *Securities Fraud Litigation Against China-Based Companies in the United States*, 46 REV. SEC. & COMMODITIES REG. 157, 159-64 (2013).
82. PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 24 (stating that U.S. firms audited 74% of CRM companies).
83. *See, e.g.*, *In re* DNTW Chartered Accountants Sec. Litig., 96 F. Supp. 3d 155 (S.D.N.Y. 2015); Special Situations Fund III QP, L.P. v. Deloitte Touche Tohmatsu CPA, Ltd., 33 F. Supp. 3d 401 (S.D.N.Y. 2014); *In re* China Organic Sec. Litig., No. 11 Civ. 8623 JMF, 2013

For example, in *Brophy v. Jiangbo Pharmaceuticals, Inc.*, the plaintiff-investors sued the independent auditor of Jiangbo Pharmaceuticals, a company with Chinese operations that became public through a reverse merger.[84] The plaintiffs argued that the auditor misrepresented the company's cash balances and failed to disclose a material related-party transaction in its public filings with the SEC.[85] As the United States Court of Appeals for the Eleventh Circuit pointed out, to sufficiently plead scienter as to an independent audit firm:

> [P]laintiffs must prove that 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.[86]

The court held that the complaint, at most, established negligence but not a "strong inference of scienter" under the PSLRA because the plaintiffs "fail[ed] to articulate a theory of the fraud with any particularity."[87]

The discrepancy between a company's AIC filings and SEC filings is one of the most common arguments plaintiffs have raised in securities litigation related to CRM companies.[88] Plaintiffs have had significant success with this allegation when suing the companies themselves and their officers and directors,[89] but this argument, curiously, has never been sufficient to adequately allege auditor liability.[90] For instance, in *Scott v. ZST Digital Networks, Inc.*, plaintiffs sued both the CRM company and its independent auditor.[91] The plaintiffs raised the same argument: there was a discrepancy between the company's AIC filings and SEC filings.[92] The court concluded that there could be a strong inference of the company scienter based on the marked disparity in revenue between the

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WL 5434637 (S.D.N.Y. Sept. 30, 2013); *In re* Longtop Fin. Techs. Ltd. Sec. Litig., 910 F. Supp. 2d 561 (S.D.N.Y. 2012).

84. 781 F.3d 1296, 1299 (11th Cir. 2015).

85. *Id.* at 1298-1300.

86. *Id.* at 1307.

87. *Id.* The court pointed out that the complaint did not: (1) identify the ways in which the audit was deficient, (2) allege that the audit firm had extensive involvement with the company beyond what was required, or (3) allege facts sufficient to support a connection between the SEC's informal, non-public investigation of Jiangbo and the audit firm's state of mind. *See id.*

88. *See* Pietrzak et al., *supra* note 81, at 164-65.

89. *See id.* at 165.

90. *See, e.g.*, *In re* Puda Coal Sec. Inc., 30 F. Supp. 3d 230 (S.D.N.Y. 2014); Hanson v. Frazer, LLP, No. 12 Civ. 3166 JSR, 2013 WL 5372749 (S.D.N.Y. Sept. 24, 2013); Scott v. ZST Dig. Networks, Inc., No. CV 11-0353 GAF JCX, 2012 WL 538279 (C.D. Cal. Feb. 14, 2012).

91. 2012 WL 538279, at *1.

92. *See id.* at *2.

two sets of filings, and the company's ambiguous explanation of those discrepancies.[93] However, the claim against the auditor was rejected by the court for not alleging the auditor's actual knowledge of the existence of the AIC files, even though plaintiff offered evidence that the defendant was "an experienced auditor of Chinese issuers' financials."[94]

The most important reason it is easier to hold officers and directors liable is that they are the individuals who maintain both sets of files and are therefore responsible for any discrepancies between the two.[95] As for independent auditors, it is nearly impossible to prove auditors' actual knowledge of the foreign filings, as in *ZST Digital Networks*,[96] or to argue that auditing standards require the foreign filings to be obtained, as in *In re Puda Coal Sec. Inc., Litig.*[97]

III. THE COURT'S DECISION

In the noted case, the Second Circuit relied on the scienter pleading standard, especially the recklessness theory for independent auditors.[98] After setting up the legal standard for pleading scienter and analyzing the plaintiffs' allegations against both auditor defendants, the Court affirmed the district court's denial of the plaintiffs' motion for leave to amend for failure to plead recklessness sufficiently on the part of the defendant auditors.[99]

First, relying on *Tellabs*, the court analyzed the pleading requirement of scienter and highlighted that the inference of the defendant's intent "to deceive, manipulate, or defraud" must be "cogent" and "compelling."[100] Comparing the recklessness theory to the motive theory espoused in *Kalnit*, the court stated that the plaintiffs needed to provide stronger circumstantial evidence to sufficiently allege recklessness.[101] Adhering to *Rothman*, the court emphasized that the alleged conduct must be "highly unreasonable, representing an extreme departure from the standards of ordinary care."[102] For independent

93. *See id.* at *6-7, *9.
94. *Id.* at *7-8.
95. *Id.* at *6-7.
96. *Id.* at *8.
97. *See In re* Puda Coal Sec. Inc., 30 F. Supp. 3d 230, 259 (S.D.N.Y. 2014) (stating that the auditor could do more, but it is not required under auditing standard).
98. *See In re Advanced Battery I*, 781 F.3d 638, 644-46 (2d Cir. 2015).
99. *See id.*
100. *Id.* at 645.
101. *Id.*
102. *Id.*

auditors, "the conduct must, in fact, approximate an actual intent to aid in the fraud."[103] The court characterized the test propounded in *Gould* as either that "the defendant conducts an audit so deficient as to amount to no audit at all" or the defendant "disregards signs of fraud so obvious that the defendant must have been aware of them."[104] The court did not elaborate on the two situations but stated that a GAAP violation (as in *Novak*) or a lack of due diligence (as in *S. Cherry St.*) are not sufficient.[105] Because the plaintiffs only appealed the denial of motion to leave to amend, the court assumed all the facts in the Proposed Complaint as true and only considered, as to each defendant, whether the facts would raise a strong inference of scienter based on the legal standard stated above.[106]

The plaintiffs' major complaint against Bagell Josephs was based on the significant discrepancy between ABAT's AIC filings and SEC filings.[107] The plaintiffs offered: (1) evidence that Bagell Josephs auditors visited ABAT's offices in China, so they had access to the information and (2) an accounting expert's opinion that, based on accounting standards, "no reasonable auditor would have failed to obtain ABAT's AIC filings."[108] The Second Circuit's reasoning and the district court's reasoning regarding the complaint were different.[109] The district court's reasoning mainly focused on the fact that the allegation did not state that Bagell Josephs "was actually aware" or "must have been aware" of the existence of the AIC filings.[110] Unlikely, the Second Circuit's reasoning heavily relied on the "extreme departure from the standards of ordinary care" requirement.[111] Because none of the accounting standards the plaintiffs relied on "specifically require an auditor to inquire about or review a company's foreign regulatory filings," there was no duty for

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103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.* at 645.
107. *Id.*
108. *Id.* at 643.
109. *See id.* at 645; *In re* Advanced Battery Tech., Inc. Sec. Litig. (*In re Advanced Battery II*), No. 11 Civ. 2279 CM, 2013 WL 3784134, at *6-7 (S.D.N.Y. July 18, 2013).
110. *In re Advanced Battery II*, 2013 WL 3784134, at *5. The district court focused on the fact that "a red flag will support a strong inference of scienter only if the auditor was actually aware of its existence, or if the court can reasonably infer that the auditor must have been aware of it." *Id.* at *5. The district court reasoned that the fact that Bagell Josephs' auditors went to ABAT's office in China could only prove defendant's access of information, which is not sufficient to allege actual awareness. *Id.* at *6-7. Also, the expert's opinion could only infer that defendant "should have" reviewed the AIC filings, but not "must have" reviewed. *Id.* at *6.
111. *In re Advanced Battery I*, 781 F.3d at 645.

auditors to inquire or review them;[112] accordingly, the Second Circuit concluded that there was no breach of duty and could not constitute recklessness.[113]

On appeal, the plaintiffs also argued that Bagell Josephs' duty to review ABAT's AIC filings came from ABAT's unusually high profit margins in its SEC filings.[114] The court explained that the unusually high profit margins only trigger, at most, a defendant's duty to review ABAT's SEC filings, but not its AIC filings.[115] Also, relying on *Chill*, the court stated that even if the auditor did not further investigate ABAT based on its unusually high profit margins, such misconduct still did not constitute recklessness.[116] Moreover, the plaintiffs argued that ABAT obtained access to U.S. capital markets via a reverse merger, which should have triggered the duty to review ABAT's AIC files.[117] The court pointed out that because there was no heightened scrutiny of CRM companies during the time the defendant audited ABAT, the auditor's failure to review the AIC filings did not constitute "extreme departure from the standards of ordinary care."[118] The plaintiffs also alleged that recklessness could be inferred because both AIC and SEC filings presumably relied on the same raw data, and the defendant failed to see the discrepancies.[119] The court rejected this argument and stated that it was more likely that ABAT maintained two sets of data and fed auditors false data.[120]

In addition, the plaintiffs alleged that Bagell Josephs failed to uncover ABAT's misrepresentation as to the ownership of Heilongjiang Zhongqiang Power-Tech Co., Ltd. (ZQPT),[121] and that EFP failed to discover the fraudulent nature of the Shenzhen acquisition.[122] For these two arguments, relying on the expert's opinion, the plaintiffs tried to prove that the defendants "would have" discovered the fraud if they had followed accounting standards or reasonable auditing practice.[123] Relying

112. *Id.*
113. *Id.*
114. *Id.*
115. *Id.*
116. *Id.*
117. *Id.*
118. *Id.*
119. *Id.*
120. *Id.* at 645-46.
121. *Id.* at 646.
122. *Id.*
123. *Id.*

on *Rothman*, the court rejected both arguments for the same reason: the defendants, at most, were negligent, not reckless.[124]

IV. ANALYSIS

The decision in the noted case is consistent with the growing trend of courts rejecting securities fraud actions filed against independent auditors in the context of CRM[125] and is also one of the only two federal appellate court decisions regarding them.[126] Both the noted case and the Eleventh Circuit's decision in *Jiangbo Pharmaceuticals* rejected the plaintiffs' claim for not satisfying the pleading requirement of scienter.[127] Also, the two cases relied on similar scienter standards: the Second Circuit focused on "extreme departure from the standards of ordinary care,"[128] and the Eleventh Circuit applied the "accounting practices were so deficient that the audit amounted to no audit at all" standard.[129]

The noted case is significant in its own right because it is the first appellate court case to expressly reject scienter arguments based on the alleged discrepancy between a company's SEC filings and AIC filings.[130] These arguments are common in securities litigation related to CRM.[131] When this argument is raised against the companies themselves and their officers and directors, such as in *ZST Digital Networks*, plaintiffs succeed in most cases, because it is not hard to make a cogent inference of a defendant's intent to deceive, manipulate, or defraud when the ones in charge of both filings could not explain the significant inconsistency.[132]

Courts, however, always rejected plaintiffs' same exact arguments against independent auditors. Prior to the noted case, courts analyzed such arguments in two different ways. One aspect was to consider whether the auditor was actually aware or must have been aware of the existence of the AIC filings, as illustrated by the lower court's analysis in

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124. *Id.*

125. *See supra* Part II.C.

126. *See* Brophy v. Jiangbo Pharm., Inc., 781 F.3d 1296, 1307 (11th Cir. 2015).

127. *In re Advanced Battery I*, 781 F.3d at 641; *Brophy*, 781 F.3d at 1307.

128. *In re Advanced Battery I*, 781 F.3d at 644.

129. *Brophy*, 781 F.3d at 1307.

130. Brian J. Massengill et al., *US Federal Appellate Courts Uphold Dismissal of Securities Fraud Claims Against Auditors in Two China Reverse Merger Cases*, MAYER BROWN (Mar. 30, 2015), https://www.mayerbrown.com/US-Federal-Appellate-Courts-Uphold-Dismissal-of-Securities-Fraud-Claims-Against-Auditors-in-Two-China-Reverse-Merger-Cases-03-30-2015/.

131. *See supra* Part II.C.

132. *See* Scott v. ZST Dig. Networks, Inc., No. CV 11-0353 GAF JCX, 2012 WL 538279, at *6-7 (C.D. Cal. Feb. 14, 2012).

the noted case.[133] Under this test, plaintiffs had to adequately allege the auditor's actual awareness of the filings or establish reasonable inference that they must have reviewed the filings.[134] In response to the plaintiffs' initial complaint, the district court rejected the "discrepancy" argument, because the complaint did not allege any evidence to support the claim that the auditor either actually reviewed or must have reviewed the files.[135] Following the district court's dismissal of the initial complaint, the plaintiff added more circumstantial allegations,[136] for example, that the auditors, some of whom were native Chinese speakers, traveled to China, and that the expert's opinion that the auditor's failure to review the AIC filings was unreasonable according to accounting standards.[137] Nonetheless, the district court still rejected the complaint for not meeting the pleading standard.[138] The United States District Court for the Central District of California's reasoning in *ZST Digital Networks* is identical to this analysis.[139] The court did not find the auditor had actual knowledge of the existence of the AIC files, even though the defendant was experienced regarding Chinese companies.[140]

Another way courts articulate the pleading threshold for allegations of auditor liability is in terms of what is required by auditing standards.[141] The United States District Court for the Southern District of New York's opinion in *Puda Coal Sec. Inc.* is an example of such reasoning.[142] The court concluded that the key question was "whether a reasonable auditor would have taken such steps under the circumstances, not whether a reasonable auditor could have."[143] The court admitted that the auditor could do more, but the plaintiff needs to prove "what auditors conducting audit procedures under PCAOB standards would do; how many steps and which steps would be enough."[144]

The Second Circuit's decision in the noted case is similar to the second approach, which focused on whether not reviewing the AIC

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133. *In re Advanced Battery II*, 2013 WL 3784134, at *6.
134. *Id.* at *5.
135. *Id.* at *6-7.
136. *Id.* at *2.
137. *Id.*
138. *Id.* at *7.
139. *See* Scott v. ZST Dig. Networks, Inc., No. CV 11-03531 GAF JCX, 2012 WL 538279, at *7-8 (C.D. Cal. Feb. 14, 2012).
140. *See id.*
141. *See In re* Puda Coal Sec. Inc., 30 F. Supp. 3d 230, 259 (S.D.N.Y. 2014).
142. *Id.*
143. *Id.*
144. *Id.*

filings constitutes "extreme departure from the standards of ordinary care."[145] After examining the auditing standards the plaintiffs relied on (Generally Accepted Auditing Standards, Statements on Auditing Standards, and GAAP), the court held that: (1) none of the auditing standards require independent auditors to review clients' foreign regulatory filings, and (2) even when there are red flags in the company's SEC filing, for example, unusually high profit margins, at most, such facts trigger the auditor's duty to review clients' SEC filings.[146] Furthermore, only violating auditing standards is not sufficient because the plaintiffs need to prove the "extreme departure" element.[147]

This holding of what is not required when auditing foreign clients will have widespread effects on auditing firms' practices. The decision's impact on numbers of securities fraud claims against independent auditors of CRM companies is uncertain. Lawsuits related to CRM companies peaked dramatically in 2011 and have since trailed off.[148] However, it is not clear whether such phenomena is a result of the high pleading standard courts adopted, the regulatory scrutiny by the SEC and the PCAOB,[149] or the stricter listing requirements adopted by NYSE and NASDAQ associated with reverse mergers.[150]

Aside from the implications of the Second Circuit's holding, it is still worth considering whether the discrepancy argument against auditors will ever be successful. The Second Circuit stated in the noted case that "under certain circumstances," an auditor could have a duty to inquire or review a company's foreign regulatory filings,[151] but the court did not determine under what circumstances this argument would be sufficient. Even assuming that it is established that the auditor has a legal duty to review such files, is a breach of such duty sufficient to

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145. *See In re Advanced Battery I*, 781 F.3d 638, 645 (2d Cir. 2015).

146. *Id.*

147. *Id.*

148. Kevin LaCroix, *Thinking About U.S. Securities Lawsuits Against U.S.-Listed Chinese Companies,* D&O DIARY (May 5, 2014), http://www.dandodiary.com/2014/05/articles/securities-litigation/thinking-about-u-s-securities-lawsuits-against-u-s-listed-chinese-companies/.

149. In 2010, the SEC launched investigations of U.S. auditing firms with multiple clients whose primary operations were outside of the United States. CORNERSTONE RESEARCH, INVESTIGATIONS & LITIGATION, *supra* note 23. The SEC also filed enforcement actions against several Chinese issuers, related individuals and auditing firms. *See* Zuber, *supra* note 24, at 1314-17. The PCAOB issued an audit practice alert and research note regarding the auditing practices of these companies. CORNERSTONE RESEARCH, INVESTIGATIONS & LITIGATION, *supra* note 23.

150. Ashley N. Schawang, *Missing the Mark: An Examination of the Current Government Response to the Chinese Reverse merger Dilemma*, 57 ST. LOUIS U. L.J. 219, 239-41 (2012).

151. *In re Advanced Battery I*, 781 F.3d at 645.

plead scienter? Although the Second Circuit did not answer the question, the answer could be inferred from the court's reasoning that unusually high profit margins in SEC filings only trigger, at most, duty to review SEC filings, and even failing to do so does not constitute recklessness.[152] Accordingly, it is highly possible that the Court would not rule in favor of plaintiffs even when auditors have obligation to review foreign filings.

As of yet, there are absolutely no district court or federal appellate court cases ruling this issue in favor of the plaintiffs. The only guidance might be the district court's opinion in the noted case, which stated that the court would infer that the defendant must have reviewed the AIC files if the auditor "prepared ABAT's AIC filings or advised ABAT with respect to its overseas subsidiary's accounting."[153] Because most CRM companies hired U.S. auditing firms after the completion of the reverse merger transaction, it is highly unlikely that these firms would ever be involved in the company's preparation of reports for Chinese regulators.[154] Thus, even relying on the district court's opinion, it is still difficult for plaintiffs to win this argument.

Another important issue addressed by the Second Circuit and district court in the noted case is whether a reverse merger should raise auditors' attention and trigger other obligations.[155] Both courts rejected this argument because the risks inherent in gaining access to U.S. markets through reverse mergers did not become a matter of heightened public scrutiny until 2011.[156] In regard to the auditors working for CRM companies after 2011, the district court left the question open.[157] The district court stated, however, that "there is no allegation that it was industry standard to view reverse mergers, particularly those involving China-based operations, with skepticism from 2007–2009."[158] We may infer that it could become an industry standard to audit CRM companies more carefully after 2011.[159] Assuming such an industry standard is

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152. *Id.*

153. *In re Advanced Battery II*, 2013 WL 3784134, at *7.

154. *See* PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 24.

155. *In re Advanced Battery I*, 781 F.3d at 645; *In re* Advanced Battery Tech., Inc. Sec. Litig. (*In re Advanced Battery III*), No. 11 Civ. 2279 CM, 2012 WL 3758085, at *15-16 (S.D.N.Y. Aug. 29, 2012).

156. *In re Advanced Battery I*, 781 F.3d at 645; *In re Advanced Battery III*, 2012 WL 3758085, at *15-16.

157. *In re Advanced Battery III*, 2012 WL 3758085, at *15-16 ("[L]eaving aside whether a reverse merger could be a 'red flag' for auditors working today").

158. *Id.*

159. In the auditor alert issued by the PCAOB in 2011, a proper procedure for auditing companies with substantial operations outside the United States was established. *See* PUB. CO.

established, whether auditors' failure to follow such standard alone will constitute recklessness, or if plaintiffs still need to allege "extreme departure" from such standards,[160] is not answered by any cases thus far.

V. CONCLUSION

The noted case is a typical example of securities fraud claims against CRM companies' independent auditors and presented the Second Circuit with a novel allegation—the auditor was reckless for failing to reveal the discrepancy between the company's SEC filings and AIC filings.[161] The Second Circuit's opinion is significant because it highlighted the high burden plaintiffs face in pleading scienter in Rule 10b-5 claims against independent auditing firms.[162] Moreover, it is the first time for a federal appellate court to expressly reject the discrepancy argument and clearly held that auditors have no duty to review a company's foreign regulatory filings.[163] The Second Circuit's decision will provide shields for external auditors working for CRMs to avoid liability.[164]

Within the context of Congress' clear intention to limit private liability in securities fraud claims,[165] it is not surprising that the Second Circuit decided in favor of the auditors.[166] Thus, private litigation does not appear to be the answer to investor protection in such situations.[167] The solution might be for the SEC to undertake enforcement actions against auditors, which do not need to meet the high pleading requirements, and then allocate the damages to the investors.[168] The SEC experienced some successful actions against auditors.[169] Problems may

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ACCOUNTING OVERSIGHT BD., STAFF AUDIT PRACTICE ALERT NO. 6: AUDITOR CONSIDERATIONS REGARDING USING THE WORK OF OTHER AUDITORS AND ENGAGING ASSISTANTS FROM OUTSIDE THE FIRM (July 12, 2010), http://pcaobus.org/Standards/QandA/2010-07-12_APA_6.pdf.

160. *In re Advanced Battery I*, 781 F.3d at 644.

161. *Id.* at 645.

162. *Id.* at 644.

163. *Id.* at 645.

164. *Id.* at 646.

165. *See* Steven A. Ramirez, *The Virtues of Private Securities Litigation: An Historic and Macroeconomic Perspective*, 45 LOY. U. CHI. L.J. 669, 695 (2014).

166. *In re Advanced Battery I*, 781 F.3d at 646.

167. *Id.*

168. *See* James D. Cox et al., *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 753-56 (2003).

169. For example, in December 2010, the SEC issued a cease and desist order against U.S. audit firm Moore Stephens Wurth Frazer & Torbet (MSWFT). Moore Stephens Wurth Frazer & Torbet LLP, Exchange Act Release No. 3221, 2010 WL 5167674, at *1 (Dec. 20, 2010).

arise regarding whether the SEC has sufficient resources to pursue such large numbers of cases,[170] and whether the SEC can work with Chinese regulators successfully.[171] In theory, the PCAOB could require public company auditors to inquire or review clients' foreign filings. The difficulty lies in drafting a requirement that provides a meaningful review or audit without imposing undue burden as Chinese companies' AIC filings and other accounting paperwork contain different information for different purposes, and are also subject to different reporting conventions.[172] Another solution might be to require more disclosure, especially in regard to the auditing arrangement,[173] or imposing section 11 liability of IPOs' registration statement to Form 8-K.[174] However, all such options would depend on how policy makers will come up with a viable solution.

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Twenty-four CRM companies announced auditor resignations after the cease and desist order; CORNERSTONE RESEARCH, INVESTIGATIONS & LITIGATION, *supra* note 23.

170. *See* Cox et al., *supra* note 168, at 757-60.

171. The SEC might have difficulty to get information from China, because neither the SEC, nor the PCAOB, can inspect the company's auditing abroad for no such agreements between U.S. and Chinese regulators exist. *See* Phillip Barber, *Bull in the China Market: The Gap Between Investor Expectations and Auditor Liability for Chinese Financial Statement Frauds*, 24 DUKE J. COMP. & INT'L L. 349, 356 (2013). The SEC and the PCAOB has sought to promote more cooperation between the United States and China, but these efforts have only been met with limited success. *See* Press Release, SEC, U.S. and Chinese Regulators Meet in Beijing on Audit Oversight Cooperation (Aug. 8, 2011), https://www.sec.gov/news/press/2011/2011-164.htm (stating that the SEC and PCAOB met with officials of China in Beijing, hoping to sign a bilateral agreement that allows for the PCAOB to jointly inspect the 110 Chinese auditors who have registered with the PCAOB, but the only substantive agreement was to continue talks).

172. The United States and China have adopted different accounting standards. *See* Songlan Peng & Kathryn Bewley, *Adaptability of Fair Value Accounting in China: Assessment of an Emerging Economy Converging with IFRS* (Jan. 11, 2009) (conference paper, Canada Academic Accounting Association Annual), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1326004.

173. Zuber, *supra* note 24, at 1326.

174. Under section 11, auditor bears the burden of proving that it has reasonable grounds to believe, and did believe, that the audited statements fairly presented the financial condition of the corporation in all material respects. *See* 15 U.S.C. § 77k(b)(3) (2012).

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