

---

# Second Circuit Lowers the Bar for Materiality in Exchange Act Claims Against Auditors Under Section 10(b) and Rule 10b-5

On October 31, 2024, a Second Circuit panel amended its August 2023 decision in *New England Carpenters Guaranteed Annuity & Pension Funds v. DeCarlo* after granting a motion for rehearing<sup>1</sup> and held that misstatements in an audit opinion may be sufficiently material to investors and thus potentially actionable under Section 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) and Rule 10b-5. The Second Circuit had previously affirmed the dismissal of such claims against an external auditor because its audit certification—which incorrectly certified a company’s accounting practices as compliant with Public Company Accounting Oversight Board (“PCAOB”) standards—merely reflected standardized language. On rehearing, however, the Second Circuit reversed course, concluding that misstatements in an audit opinion may be material to investors, even if they merely reflect standardized language. *DeCarlo* has the potential to significantly broaden securities fraud liability for external auditors in the Second Circuit, and more broadly.

---

## I. Factual and Procedural Background

In 2010, AmTrust, one of the world’s largest publicly traded property and casualty insurance companies, acquired Warrantech, a publicly traded company focused on providing extended service plans (“ESPs”) and warranty programs for retailers, dealers, distributors, and manufacturers.<sup>2</sup> Before the acquisition, the U.S. Securities and Exchange Commission (“SEC”) investigated Warrantech’s practice of recognizing the full amount of revenue received from its ESPs and other service contracts at the time of sale.<sup>3</sup> The SEC subsequently instructed Warrantech to instead recognize such revenue on a “straight-line basis,” *i.e.* over the life of the contract.<sup>4</sup> AmTrust, although apparently aware of the SEC’s instruction, reverted to the “time-of-sale” approach following the acquisition.<sup>5</sup>

In 2015 and 2016, AmTrust made two successful securities offerings that incorporated audit reports from its outside auditor, BDO USA LLP (“BDO”).<sup>6</sup> Notwithstanding AmTrust’s “time-of-sale” revenue recognition practice, BDO’s audit reports certified that AmTrust’s financial statements and BDO’s audit thereof were “conducted in accordance with PCAOB standards.”<sup>7</sup> In February 2017, AmTrust issued a press release announcing that it would delay filing its 2016 Form 10-K to “make immaterial corrections to errors” in its 2012–2015 financial statements and to

---

<sup>1</sup> 80 F.4th 158 (2d Cir. 2023), *amended and superseded on reh’g*, 2023 WL 11965444 (2d Cir. Oct. 31, 2024).

<sup>2</sup> *DeCarlo*, 2023 WL 11965444, at \*2.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at \*14–15.

<sup>7</sup> *Id.* at \*15–16.

disclose “material weaknesses in its internal control over financial reporting.”<sup>8</sup> AmTrust ultimately restated its 2012–2016 financial results in April 2017 and revealed that it made “two material accounting errors,” including the use of the “time-of-sale” revenue recognition approach.<sup>9</sup>

### **District Court Proceedings**

After AmTrust announced the delay of its 2016 Form 10-K filing, its stock price fell, and, in March 2017, AmTrust shareholders commenced a putative class action in the United States District Court for the Southern District of New York against AmTrust, its officers (collectively, the “AmTrust Defendants”), members of its board of directors (the “Director Defendants”), BDO, and certain of the entities that underwrote AmTrust’s securities offerings (the “Underwriter Defendants”).<sup>10</sup>

On September 9, 2019, the court dismissed the plaintiffs’ second amended complaint without prejudice, concluding that the plaintiffs’ alleged misstatements were either non-actionable statements of opinion or had not been adequately alleged to be false, misleading, and material.<sup>11</sup> The court held, with respect to the Exchange Act and Rule 10b-5 claims against BDO, that the plaintiffs failed to plead loss causation because they did not allege any “disclosure and subsequent negative effect” on AmTrust’s stock price following BDO’s audit certification.<sup>12</sup> Moreover, because the court dismissed the Exchange Act and Rule 10b-5 claims against BDO on materiality and loss causation grounds, it did not address scienter.

The plaintiffs subsequently filed a third amended complaint, alleging that the defendants made material misstatements about AmTrust’s financial condition in violation of Sections 11, 12, and 15 of the Securities Act of 1933 (the “Securities Act”), Sections 10(b) and 20(a) of the Exchange Act, and Rule 10b-5.<sup>13</sup> The court dismissed the plaintiffs’ third amended complaint on April 20, 2020 for largely the same reasons it dismissed the second amended complaint, finding that the plaintiffs failed to correct the defects present in their prior complaint.<sup>14</sup> The plaintiffs appealed to the Second Circuit.

### **The Second Circuit’s August 2023 Decision**

On August 23, 2023, the Second Circuit, reviewing *de novo*, affirmed in part and vacated and remanded in part.<sup>15</sup> The court affirmed the dismissal of the plaintiffs’ Exchange Act and Rule 10b-5 claims against BDO and the AmTrust Defendants and largely vacated the dismissal of the plaintiffs’ Securities Act claims against the AmTrust Defendants, Underwriter Defendants, and Director Defendants.<sup>16</sup>

---

<sup>8</sup> *Id.* at \*3; Complaint ¶¶ 5, 32, *New England Carpenters Guaranteed Annuity & Pension Funds v. DeCarlo*, No. 17-cv-01545 (S.D.N.Y. Mar. 1, 2017).

<sup>9</sup> *DeCarlo*, 2023 WL 11965444, at \*1, \*3.

<sup>10</sup> *Id.* at \*1, \*17. Plaintiffs brought the following claims: against (1) the **AmTrust Defendants**, claims under Sections 11, 12, and 15 of the Securities Act, Sections 10(b) and 20(a) of the Exchange Act, and Rule 10b-5; (2) **AmTrust**, claims under Section 12 of the Securities Act; (3) the **Underwriter Defendants** and **Director Defendants**, claims under Sections 11 and 12 of the Securities Act; (4) certain **Director Defendants**, claims under Section 15 of the Securities Act; and (5) **BDO**, claims under Section 11 of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5.

<sup>11</sup> See *In re AmTrust Fin. Servs., Inc. Sec. Litig.*, 2019 WL 4257110 (S.D.N.Y. Sept. 9, 2019).

<sup>12</sup> *Id.* at \*35.

<sup>13</sup> *DeCarlo*, 2023 WL 11965444, at \*1, \*3.

<sup>14</sup> See *In re AmTrust Fin. Servs., Inc. Sec. Litig.*, 2020 WL 2787117, at \*1–4 (S.D.N.Y. Apr. 20, 2020).

<sup>15</sup> See *DeCarlo*, 80 F.4th 158.

<sup>16</sup> The Second Circuit affirmed the dismissal of the plaintiffs’ claims against the AmTrust Defendants under Section 11 of the Securities Act (concerning their Sarbanes Oxley Act certifications). The court also affirmed the dismissal of the plaintiffs’ claims against BDO under Section 11 of the Securities Act.

**First**, the Second Circuit affirmed the district court’s dismissal of the plaintiffs’ claims against BDO under the Exchange Act and Rule 10b-5, which stemmed from BDO’s audit certification of AmTrust’s financial statements.<sup>17</sup> The Second Circuit concluded that BDO could not be liable for that certification—specifically, the statement that BDO “conducted its audits in accordance with standards promulgated by the [PCAOB]”—because that statement merely reflected standardized language and was thus immaterial, and because the complaint did not allege “any link” between BDO’s misstatements in the audit certification and the “material errors” in AmTrust’s 2013 Form 10-K.<sup>18</sup> In other words, the plaintiffs failed to plead materiality because they did not sufficiently allege that a “reasonable investor would have considered” the misstatement “significant in making investment decisions.”<sup>19</sup> Because the court affirmed the dismissal on materiality grounds, it did not address loss causation or scienter.

**Second**, the court affirmed dismissal of the Exchange Act claims against the AmTrust Defendants, holding that the plaintiffs failed to plead scienter adequately because they did not sufficiently allege “motive and opportunity to commit fraud” or “strong circumstantial evidence of conscious misbehavior or recklessness.”<sup>20</sup>

**Third**, the Second Circuit largely vacated the district court’s dismissal of the plaintiffs’ Securities Act claims against the AmTrust Defendants, Underwriter Defendants, and Director Defendants, reasoning that their incorrect recognition of ESP revenue was actionable, even though it “reflected the exercise of subjective judgment.”<sup>21</sup> The Second Circuit noted that the district court, in reaching the opposite conclusion, did not “have the benefit” of the Second Circuit’s “latest guidance” regarding actionable statements from *Abramson v. Newlink Genetics Corporation*,<sup>22</sup> in which the court explained that statements of opinion may be actionable if they contain “an embedded statement of fact that is not true.”<sup>23</sup> Applying this reasoning, the Second Circuit rejected the Defendants’ argument that AmTrust’s determination of when to recognize ESP revenue was merely a “subjective judgment call.”<sup>24</sup>

### ***Motion for Rehearing & SEC Amicus Curiae Brief in Support Thereof***

On September 6, 2023, the plaintiffs moved for rehearing of their Exchange Act claims against BDO and the AmTrust Defendants, asserting that the Second Circuit erred by overlooking key (1) allegations regarding BDO’s misstatements to AmTrust investors and (2) evidence of the AmTrust Defendants’ scienter.<sup>25</sup>

In support of the plaintiffs’ motion for rehearing and at the Second Circuit’s request, the SEC submitted an *amicus curiae* brief urging the court to reconsider its dismissal of the claims against BDO, given the significance of audit certifications to the investing public.<sup>26</sup> The SEC explained that independent auditors are the “gatekeepers” to the public securities markets—thus allowing investors to rely on financial statements without “the fear of loss from reliance on inaccurate information”—and, on that basis, asked the Second Circuit to hold that (1) standardized

---

<sup>17</sup> *Id.* at 181.

<sup>18</sup> *Id.* at 181–82.

<sup>19</sup> *Id.* at 182 (quoting *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 161 (2d Cir. 2000)).

<sup>20</sup> *Id.* at 177–78.

<sup>21</sup> *Id.* at 168–72, 180.

<sup>22</sup> *Id.* at 169 (citing 965 F. 3d 165 (2d Cir. 2020)).

<sup>23</sup> *Id.* at 171 (citing *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pensions Fund*, 575 U.S. 175, 186 (2015)).

<sup>24</sup> *Id.* at 172–174.

<sup>25</sup> Appellants’ Mot. for Reh’g at 1–3, 12, *New England Carpenters Guaranteed Annuity & Pension Funds v. DeCarlo*, No. 20-1643, ECF No. 176 (2d Cir. Sept. 6, 2023).

<sup>26</sup> Brief for the SEC as *Amicus Curiae*, *New England Carpenters Guaranteed Annuity & Pension Funds v. DeCarlo*, No. 20-1643, ECF No. 202 (2d Cir. Feb. 16, 2024).

language does not render statements in auditor certifications immaterial and (2) plaintiffs need not plead a link between an auditor's misstatement and specific financial errors.<sup>27</sup>

## II. The Second Circuit's Amended Decision

On October 31, 2024, the Second Circuit granted the plaintiffs' motion for rehearing—as to the claims against BDO under Section 10(b) of the Exchange Act and Rule 10b-5—and concluded on rehearing that the district court's dismissal of those claims was error.<sup>28</sup> The Second Circuit held that the plaintiffs adequately pleaded materiality, loss causation, and scienter in connection with BDO's misleading statements certifying that AmTrust's financials were PCAOB-compliant.

*First*, the Second Circuit found that the plaintiffs adequately pleaded that the misstatements within BDO's 2013 Audit Opinion were material, notwithstanding that the language was "standardized."<sup>29</sup> The court explained that, despite its generality, the challenged language was not "so general that a reasonable investor would not depend on it as a guarantee."<sup>30</sup> The certification language was also material because, as the SEC argued in its *amicus curiae* brief,<sup>31</sup> it "conveyed to investors that AmTrust's audited financial statements were reliable."<sup>32</sup> Indeed, BDO could not have issued an unqualified audit opinion without the certification language, which would have been "significant" because it would have "alerted investors to potential problems" in AmTrust's financial reports.<sup>33</sup> Accordingly, the court found that the plaintiffs adequately alleged materiality despite not establishing "a link" between BDO's certification and specific errors in AmTrust's financial statements.<sup>34</sup> This holding reflected the court's acceptance of the SEC's argument that an audit certification conveys material information and need not be tied to specific errors in financial statements because a deficient certification "eliminates the basis for investors' reliance on the auditor and subjects investors to increased (and hidden) risk."<sup>35</sup>

*Second*, the Second Circuit explained that the district court erred in concluding that the plaintiffs failed to allege loss causation adequately.<sup>36</sup> Because the plaintiffs relied on a corrective disclosure theory—that is, the price drop occurred not when the misstatements were made, but when their falsity was ultimately revealed to the public—they had to plausibly allege a "disclosure" of BDO's misstatements by which "the available public information" about BDO's audit opinion was "corrected."<sup>37</sup> In other words, the plaintiffs had to allege a corrective disclosure and subsequent decline in AmTrust's stock price. The Second Circuit held that plaintiffs' allegations regarding a 2017 *Wall Street Journal* article discussing BDO's "fail[ure] to complete the necessary checks" before certifying the audit and the subsequent drop in price of AmTrust securities satisfied this burden.<sup>38</sup> In so holding, the Second Circuit

---

<sup>27</sup> *Id.* at 8, 11–15.

<sup>28</sup> *DeCarlo*, 2023 WL 11965444, at \*16–18, \*18 n. 20.

<sup>29</sup> *Id.* at \*17.

<sup>30</sup> *Id.* (quoting *ECA & Loc. 134 IBEW Joint Pension Tr. of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 206 (2d Cir. 2009)).

<sup>31</sup> See Brief for the SEC as *Amicus Curiae*, *supra* note 24, at 5, 11–12.

<sup>32</sup> *DeCarlo*, 2023 WL 11965444, at \*17 (citing *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984)).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> Brief for the SEC as *Amicus Curiae*, *supra* note 24, at 13–14.

<sup>36</sup> *DeCarlo*, 2023 WL 11965444, at \*17.

<sup>37</sup> *Id.* (quoting *Carpenters Pension Tr. Fund of St. Louis v. Barclays PLC*, 750 F.3d 227, 233 (2d Cir. 2014)).

<sup>38</sup> *Id.*

---

rejected its prior reasoning—that the plaintiffs could not allege loss causation given the three-year gap between the article and BDO’s audit certification—because there was a “clean match” between the audit opinion and the subsequent disclosure. The article “revealed the specific deficiencies that rendered the audit opinion misleading.”<sup>39</sup>

*Third*, the Second Circuit concluded that the plaintiffs sufficiently pleaded scienter by alleging that BDO senior partners and managers knew and consciously concealed that its audit of AmTrust’s financial reports did not comply with PCAOB standards.<sup>40</sup> Those allegations sufficiently demonstrated recklessness and thus scienter because they concerned BDO “consciously cover[ing] up its *own* misrepresentation that its audit complied with PCAOB standards.”<sup>41</sup> The court thus rejected BDO’s argument that “accounting irregularities” do not rise to “reckless conduct sufficient for 10(b) liability.”<sup>42</sup>

---

### III. Conclusion

The Second Circuit’s amended decision in *DeCarlo* indicates that auditors may be held liable for securities fraud under the Exchange Act for misstatements in audit certifications and opinions, even if the language is general or standardized. While *DeCarlo* speaks only to the standard for allegations at the pleading stage, claims in the Second Circuit against external auditors based on alleged misstatements within audit certifications and opinions may increase as a result of the court’s holding. This will be an area to watch, because—as courts grapple with the implications of *DeCarlo*—individual accountants now face liability under a standard of negligence, rather than recklessness, per October 19, 2024 amendments to PCAOB Rule 3502. Cahill’s memorandum discussing the recent amendment to PCAOB Rule 3502 can be found [here](#).

\* \* \*

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 in it, please do not hesitate to call or email authors Joel Kurtzberg (Partner) at 212.701.3120 or [jkurtzberg@cahill.com](mailto:jkurtzberg@cahill.com); John MacGregor (Partner) at 212.701.3445 or [jmacgregor@cahill.com](mailto:jmacgregor@cahill.com); Jason Rozbruch (Associate) at 212.701.3750 or [jrozbruch@cahill.com](mailto:jrozbruch@cahill.com); Jessica Urgo (Associate) at 212.701.3882 or [jurgo@cahill.com](mailto:jurgo@cahill.com); or email [publicationscommittee@cahill.com](mailto:publicationscommittee@cahill.com).

---

<sup>39</sup> *Id.* (quoting *Ark. Tchr. Ret. Sys. v. Goldman Sachs Grp., Inc.*, 77 F.4th 74, 80 (2d Cir. 2023)).

<sup>40</sup> *Id.* at \*18.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* (quoting *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000)).

This memorandum is for general information purposes only and is not intended to advertise our services, solicit clients or represent our legal advice.