

10-2311-cv

(Docket Number in District Court: 09-cv-03161)

IN THE
United States Court of Appeals
FOR THE SECOND CIRCUIT

ALFRED FAIT, Individually and on behalf of all others situated,

Plaintiff,

HOWARD M. RENSIN, Trustee for the HOWARD M. RENSIN IRA,

Plaintiff-Appellant,

v.

REGIONS FINANCIAL CORPORATION, REGIONS FINANCING TRUST III, C. DOWD RITTER, SAMUEL W. BARTHOLOMEW, JR., GEORGE W. BRYAN, DAVID J. COOPER, EARNEST W. DEAVENPORT, JR., DON DEFOSSET, JAMES R. MALONE, SUSAN W. MATLOCK, CHARLES D. MCCRARY, CLAUDE B. NIELSEN, JORGE M. PEREZ, LEE J. STYSLINGER, III, SPENCE L. WILSON, JOHN R. ROBERTS, ERNST & YOUNG LLP, UBS SECURITIES LLC, CITIGROUP GLOBAL MARKETS INC., MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, WACHOVIA CAPITAL MARKETS, LLC, MORGAN STANLEY & CO. INCORPORATED, MORGAN KEGAN & COMPANY, INC.,

Defendants-Appellees.

HOWARD M. RESIN, Trustee,

Movant.

*On Appeal from the United States District Court
for the Southern District of New York*

**BRIEF OF DEFENDANT-APPELLEE
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PRELIMINARY STATEMENT

Plaintiff allegedly bought securities of a subsidiary of defendant Regions Financial Corp. (“Regions”), which were sold in an April 2008 offering. The offering documents included Regions’ 2007 10-K; the 10-K included Regions’ financial statements for the year ended December 31, 2007, which Ernst & Young LLP (“E&Y”) audited and reported upon. The claim against E&Y—under Section 11 of the Securities Act of 1933—is based solely on E&Y’s audit report on Regions’ 2007 financial statements. Plaintiff’s appellate brief barely mentions E&Y, but the complaint alleges that the 2007 financial statements were false and misleading because over a year later, in January 2009, Regions increased its loan loss reserves by \$1 billion and decreased its goodwill by \$6 billion. Plaintiff says Regions should have made the same changes at year-end 2007, because it was apparent then that Regions would suffer substantial losses in the future on its real estate loans due to weaknesses in the real estate market, particularly in Florida, where AmSouth Corporation (which Regions acquired in 2006) had made many loans.

The district court correctly dismissed the claim against E&Y. Plaintiffs assert that allegations of negligence are sufficient to plead a Section 11 claim here, but negligence is not the applicable standard in this case. Setting loan loss reserves and an amount for goodwill—which are done by an auditor’s client—are matters

of opinion because they depend on predictions about future business events and require complex judgments involving a host of factors—there simply is no one correct answer, but rather a range of possibilities from which an informed opinion must be made. Under *Virginia Bankshares v. Sandberg*, 501 U.S. 1083 (1991), and subsequent decisions, securities claims based on an opinion must be dismissed unless the plaintiff alleges subjective falsity—namely, that the defendant did not genuinely believe its opinion at the time. There are no such allegations here. Plaintiff does not dispute that the claim against E&Y must be dismissed if subjective falsity is required.

Even under the negligence standard for which plaintiff argues, plaintiff's claim fails because it is a classic exercise in hindsight pleading that does not allege a plausible claim of material misstatements of fact at the time the registration statement became effective. The 2007 10-K states that by the end of 2007 Regions had increased its loss reserves by nearly 400%. The complaint charges that the reserves should have been increased by even *more*, because it was supposedly obvious that the Florida real estate market and the economy would do so poorly in the upcoming year that Regions, at the end of 2007, should have increased its loss reserves by \$1 billion and written down its goodwill by \$6 billion. (If it was so obvious, it is a mystery why plaintiff nonetheless invested in a bank with a large—and fully disclosed—portfolio of Florida real estate loans.) In other words, the

changes that Regions made to its reserves and goodwill in January 2009—*after* the cataclysmic events that rocked the world’s economy in the fall of 2008—should have been foreseen by Regions (and its auditor, E&Y) long *before* those events occurred.

The federal securities laws do not require issuer or auditor clairvoyance. But in the last analysis that is what the complaint in this case seeks to do—take the market meltdown of 2008 and argue that issuers and auditors should have foreseen that it would occur. Adopting such a theory would reverse this Court’s longstanding rejection of hindsight pleading in securities cases. Moreover, an auditor has no duty to tell its client about or disclose in its audit report trends in the client’s business, much less to accurately forecast the course of the global economy. And the complaint provides no basis to plausibly infer that E&Y—long before the global economy nearly collapsed in the fall of 2008—knew that Regions’ 400% increase in loss reserves in 2007 would turn out to be insufficient and knew that Regions attributed an improper amount to goodwill. The complaint has no allegations about specific Regions’ loans that would indicate that the 2007 financial statements were wrong at the time. Instead, the complaint is filled with allegations about the real estate market and the economy generally—information available to anyone, including the plaintiff—but that is a legally insufficient basis for inferring that Regions’ loss reserves and goodwill were misstated.

The claim against E&Y also fails because the bespeaks caution doctrine requires dismissal. The risk that plaintiff asserts was hidden—that increased real estate losses might result from a weakening housing market, thereby causing Regions to increase its loan loss reserves and reduce the amount attributable to goodwill—was the subject of numerous warnings in the offering documents.

STATEMENT OF ISSUES

1. Whether the district court correctly dismissed the claim against E&Y because setting loan loss reserves and attributing an amount to goodwill are matters of opinion and judgment, requiring subjective falsity allegations under *Virginia Bankshares*.

2. Whether, alternatively, the judgment should be affirmed because:

(a) plaintiff does not allege a plausible claim in asserting that the changes in loss reserves and goodwill made in January 2009—shortly after the global economy almost collapsed in the fall of 2008—should have been made at year-end 2007; or

(b) the warnings in the offering documents require dismissal under the bespeaks caution doctrine.

STATEMENT OF THE CASE

A. Nature Of The Case.

Plaintiff filed this putative class action in April 2009. Alleging that the

prospectus and registration statement for the April 2008 offering were materially false and misleading, the Corrected First Amended Complaint (JA1021-1118) asserts claims against Regions, the Regions subsidiary that issued the securities, members of Regions' board of directors, six underwriters for the offering, and E&Y, which audited Regions' financial statements for the year ended December 31, 2007. JA1022 ¶ 1; JA1036-41 ¶¶ 33-58. As noted earlier, E&Y's audit report was included in Regions' 2007 Form 10-K filing with the SEC; the 10-K was incorporated in the registration statement for the April 2008 offering. JA1028-29 ¶¶ 18-19.

Plaintiff asserts one claim against E&Y: an alleged violation of Section 11, which provides for liability for a registration statement that "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). See JA1106-07 ¶¶ 229-39. All of the other defendants are also sued under Section 11. *Id.* In addition, Regions, its subsidiary, and the underwriters allegedly violated Section 12(a)(2) of the 1933 Act; Regions and its directors also allegedly violated Section 15 of that Act. JA1108-09 ¶¶ 240-49.

Regions' 2007 financial statements were never restated. Plaintiff, however, alleges that due to E&Y's negligence, its audit report stated falsely that the financial statements satisfied generally accepted accounting principles ("GAAP")

and that E&Y's audits complied with generally accepted auditing standards ("GAAS"). JA1034 ¶ 27; JA1079 ¶ 139; JA1097 ¶ 192; JA1101-02 ¶¶ 209, 212. First, plaintiff asserts, Regions' financial statements misstated the amount attributable to goodwill from the AmSouth transaction, and E&Y negligently audited this item. JA1100 ¶ 205; JA1102-03 ¶¶ 212, 214. Second, plaintiff alleges that the financial statements improperly accounted for Regions' loan loss reserves and that E&Y negligently audited this item as well. *Id.* These allegations concern only E&Y's 2007 audit report; there is no claim that E&Y's 2006 audit report was inaccurate.

B. The Course Of Proceedings And Disposition Below.

Before filing the amended complaint, when queried by the district court about what had to be pleaded to plead an adequate Section 11 claim concerning such items as a bank's loss reserves, plaintiff's counsel stated that "our allegation" is that the defendants "knew at the time that [the statement] was incorrect" and promised the district court that "we will plead fraud ... we will plead it in particularity." JA31-32. Nonetheless, when the amended complaint was actually filed, it did not fulfill plaintiff's counsel's promise to the district court. To the contrary, the complaint "expressly excludes and disclaims any allegation that could be construed as alleging fraud or intentional or reckless misconduct." JA1106 ¶ 230. The defendants moved to dismiss, pointing out that plaintiff had not provided

the promised pleading and that, among other things, subjective falsity was not alleged. In a published opinion (712 F. Supp. 2d 117), Judge Kaplan granted the motions, dismissing the complaint with prejudice. SA1; SA19; SA26. Plaintiff did not seek leave to amend.

Citing the Supreme Court’s decision in *Virginia Bankshares* and other cases, the district court explained that “[a]n opinion is actionable under Section 11 or 12 only if the complaint alleges that the speaker did not truly hold the opinion at the time it was issued.” SA8. The court held that this principle applied to—and required dismissal of—all of plaintiff’s claims.

The district court held that the alleged overstatement of goodwill in the 2007 10-K—the excess of Regions’ acquisition price for AmSouth over the fair value of AmSouth’s assets—“did not involve misstatements or omissions of material *fact*” because the value of those assets “was not a matter of objective fact” and plaintiff has not “pointed to any ... objective standard of value.” SA10. “Rather, the value of such assets is a matter of judgment and opinion.” SA10-11. And “[g]iven the lack of any objective or readily determinable value for the AmSouth assets,” the amount attributed to goodwill could not be a false statement unless it “did not reflect management’s ‘honest opinion’” of that value. SA11. Because of “the absence of particularized allegations that management believed that the goodwill figure was materially overstated,” the complaint was legally insufficient. SA12. A

June 2008 letter from the SEC that asked Regions how it had determined that its goodwill balance was not impaired “does not alter this conclusion.” SA13. After Regions explained why its goodwill was not impaired, the SEC “had ‘no further comments.’” *Id.* And because this correspondence “occurred nearly two months after the Offering,” it “does not support an inference that Regions was aware that its goodwill was impaired at the time” of the alleged misstatements. *Id.*

Similarly, the court ruled, loan loss reserves “reflect management’s opinion as to the likelihood of future loan losses and their magnitude.” SA14. Regions’ reserves “were statements of opinion by defendants as to the portion of the stated value of Regions’ loans that would prove to be uncollectable”—whether Regions “had adequate reserves for its predicted loan losses is not a matter of objective fact.” *Id.* And because the complaint “is devoid of any allegation that defendants did not truly hold those opinions at the time they were made public,” the allegations about loan loss reserves do not state a claim. SA15.

Finally, the court noted that the claims against E&Y “are derivative of plaintiff’s claims for misstatements of goodwill and loan loss reserves, and, in any event, insufficient as a matter of law.”¹ SA12 n.46.

¹ The court also dismissed plaintiff’s conclusory allegations about Regions’ internal controls because they “are duplicative of plaintiff’s claims for misstatements of goodwill and loan loss reserves and, in any case, are unsupported by appropriate facts.” SA16. Plaintiff does not challenge this ruling on appeal.

STATEMENT OF FACTS

A. Plaintiff's Theory.

Regions provides banking and other financial services. JA1036 ¶ 33. The complaint alleges that although Regions increased its loan loss reserves by \$1 billion and wrote down its goodwill by \$6 billion in January 2009, it should have taken the same action at the end of 2007. JA1026-27 ¶¶ 12, 14-15; JA1073 ¶ 129; JA1085 ¶ 158. Plaintiff alleges that Regions' 2007 financial statements were false because they did not include the revised amounts for loss reserves and goodwill that the company adopted in January 2009. JA1026-27 ¶¶ 12, 14; JA1034-35 ¶ 27; JA1072-73 ¶¶ 126, 129; JA1079 ¶ 139; JA1085 ¶ 158; JA1090 ¶ 173.

Plaintiff traces Regions' problems to its November 2006 acquisition of AmSouth, a bank "heavily invested in the real estate markets in the South" that, unbeknownst to Regions, "was about to be decimated by the impending collapse in mortgage-related asset values." JA1023 ¶¶ 4-5. Regions paid \$10 billion for AmSouth, and it attributed more than \$6 billion of that amount to goodwill on Regions' books. *Id.* ¶ 5; JA1025 ¶ 10. (Plaintiff seems to suggest at one point that all of Regions' \$11.5 billion in goodwill was attributable to the AmSouth merger. See Pl. Br. 54. The complaint, however, makes clear that \$6.2 billion of the goodwill on Regions' balance sheet at year-end 2007 was attributable to AmSouth. JA1025 ¶ 10.)

After the 2006 AmSouth acquisition, the real estate market in Florida and elsewhere slowed, resulting generally in declining real estate values and increasing numbers of foreclosures during 2007 and 2008. JA1023-25 ¶¶ 6-8; JA1048-50 ¶¶ 79-83; JA1053-55 ¶¶ 90-91, 93-97; JA1058 ¶ 103; JA1075-78 ¶ 136. The complaint contains allegations about the real estate market and the economy in general (see *id.*), but it has no allegations about specific loans by Regions or AmSouth. Nonetheless, plaintiff alleges, E&Y should have known that the general difficulties in the real estate market, including in Florida, meant that Regions' 2007 financial statements were false and misleading because the loss reserves were too low and the amount for goodwill attributed to the AmSouth merger was too high. JA1073 ¶ 129; JA1079 ¶ 139; JA1085 ¶ 158; JA1091 ¶ 176; JA1100-03 ¶¶ 205-07, 209, 212, 214; JA1107 ¶ 236.

B. Accounting Concepts.

Loan loss reserves are amounts that a bank sets aside “based on its expectations about future loan losses.” American Bankers Association, *BANKING TERMINOLOGY* 215 (3d ed. 1989). Thus, “[w]hen a company sets its reserves, it is essentially making a prediction.” *Wells v. HBO*, 1994 WL 228842, at *17 (N.D. Ga. Apr. 19, 1994), *aff'd*, 67 F.3d 314 (11th Cir. 1995) (table). “[T]he taking of loan loss reserves is based on managerial guesswork about the future economic fortune of a ... real estate loan portfolio,” which “depends on the economics of the

real estate market.” *First Nationwide Bank v. Gelt Funding Corp.*, 820 F. Supp. 89, 95 (S.D.N.Y. 1993), *aff’d*, 27 F.3d 763 (2d Cir. 1994). As the complaint alleges, a loan is impaired, and thus the loss reserve should be increased, when it is “‘probable’” that the loan will not be repaid in full. JA1089 ¶ 169 (quoting Financial Accounting Standards Board, *Statement of Financial Accounting Standards* (“SFAS”) No. 114 ¶ 8, JA916). “Probable” means that “[t]he future event or events are likely to occur.” SFAS No. 114 ¶ 10 (JA916-17). See also JA1090 ¶ 172 (“To calculate the Company’s loss exposure, Regions was required under GAAP, to evaluate the likelihood of future cash flows (in the form of repayments of principle [sic] and interest”).

Goodwill is defined as

the excess of the purchase price over the fair market value of an asset. It reflects the value of intangible assets like reputation, brand name, good customer relations, good employee relations, any patents and proprietary technology, and other intangibles that improve a company’s business.

In re Vivendi Universal, 242 F.R.D. 76, 81 n.3 (S.D.N.Y. 2007), *reconsideration denied*, 2009 WL 855799 (S.D.N.Y. Mar. 31, 2009). Put differently, the complaint alleges that goodwill is “an asset because future economic benefits are expected from it in combination with the future benefits of the other assets acquired in the acquisition.” JA1081-82 ¶ 146 (citing SFAS No. 141, JA926-66). When goodwill is higher than an asset’s fair market value, it reflects the “control premium” that an

acquiring company often pays for control of another company: “[s]ubstantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity”; consequently, the amount attributed to goodwill “is different from measuring the fair value of that entity’s individual equity securities.” SFAS No. 142 n.16 (JA985). Goodwill is tested “at least annually for impairment.” JA971 (SFAS No. 142).

C. The 2007 10-K.²

Regions’ 2007 10-K (JA334-484) stated explicitly that the faltering real estate market was expected to cause increased loan losses. Specifically, because “the weakness in the homebuilder portfolio is expected to continue well into 2008” and Regions expected that losses on real estate loans would “continue to rise” during 2008, the 10-K “anticipated that our non-performing asset and charge-off levels will continue to increase in 2008.” JA351, 400; see JA399 (“Management anticipates that the housing industry will remain weak throughout 2008”). Thus, the 2007 10-K noted that Regions had increased its loan loss reserves by about 400%: “[d]uring 2007, the provision for loan losses from continuing operations increased to \$555.0 million compared to \$142.4 million in 2006”; the higher 2007

² Regions filed the 2007 Form 10-K with the SEC in February 2008; the complaint refers repeatedly to the 10-K (*e.g.*, JA1025-26 ¶¶ 10, 12-13; JA1029-34 ¶¶ 19-24); and it is incorporated by reference in the registration statement at issue. Accordingly, the 10-K may be considered in deciding whether the complaint states a claim. *ATSI Communications v. Shaar Fund*, 493 F.3d 87, 98 (2d Cir. 2007).

figure resulted from “an increase in management’s estimate of inherent losses in its residential homebuilder portfolio, ... generally weaker conditions in the broader economy,” and AmSouth “loan losses added to the portfolio” after the merger. JA361.

In short, the 2007 10-K contained multiple disclosures and warnings about a “relatively severe” housing slowdown in Florida and Georgia, where Regions’ residential loans were “concentrated”; the 10-K also warned of a “significantly increasing” “risk of recession,” including increased unemployment. JA361, 381, 399; see pp. 52-53, *infra*.

The 2007 10-K cautioned that although Regions believed “that our allowance for credit losses is adequate ... if our assumptions or judgments are wrong, our allowance for credit losses may not be sufficient to cover our actual credit losses,” and “[w]e may have to increase our allowance in the future ... to adjust for changing conditions and assumptions, or as a result of any deterioration in the quality of our loan portfolio.” JA351; see also pp. 52-53, *infra*. For goodwill, the 10-K warned that “[a]dverse changes in the economic environment, declining operations of the business unit, or other factors could result in a decline in implied fair value of excess purchase price,” in which case “a loss would be recognized.” JA366; accord JA424.

D. The April 2008 Offering.

In April 2008, the Regions subsidiary sold the securities at issue. JA1022 ¶ 1; JA1034 ¶ 25. Plaintiff allegedly bought securities pursuant or traceable to that offering. JA1036 ¶ 32.

E. The SEC Letter.

In June 2008, the SEC asked Regions about its 2007 financial statements. JA796; see also JA1026 ¶ 13; JA1062 ¶ 111; JA1085 ¶ 157 (paragraphs in the complaint citing the SEC letter). The SEC asked Regions to explain “[h]ow you determined that your goodwill balance is not impaired” and to “specifically address how you took into consideration the fact that you have been trading at a market value that is below your book value.” JA797.

Regions’ response explained that it “evaluated goodwill at the segment level for impairment in the annual impairment test in the fourth quarter of 2007 and determined that goodwill was not impaired in any segment at December 31, 2007.” JA803. Regions “evaluated these segments using both market and income approaches, taking into account various factors,” which it listed, including “future cash flow projections.” *Id.* Regions also tested goodwill for impairment during the second quarter of 2008; that test likewise “resulted in no impairment.” JA804. As for the recent “trend of lower trading value relative to book value,” Regions said its “management could not conclude that this was a long-term trend,

particularly when our stock price was trading above book value in the fourth quarter of 2007.” JA803. Regions also noted that “given the relatively small difference between our stock price and our book value per share, we determined that a potential buyer would offer a control premium for our business franchise that would adequately cover these differences between trading prices and book values.” *Id.* Regions said it would “continue to monitor market conditions and determine if any further interim review of goodwill is needed.” JA804.

Ten days later, on July 10, 2008, the SEC notified Regions that “[w]e have completed our review of your Form 10-K and have no further comments at this time.” JA807. The complaint does not allege that the SEC ever took any further action with respect to Regions’ 2007 10-K or its 2007 financial statements.

SUMMARY OF ARGUMENT

I. Plaintiff misreads the Supreme Court’s decision in *Virginia Bankshares*. The Court held that an opinion is actionable as a false statement of fact under Section 14 of the Securities Exchange Act of 1934 only when it is both subjectively false (because it misstates that the speaker believes what he says) and objectively false (because the opinion stated was incorrect). As plaintiff would have it, only the latter is required in cases involving opinions, but courts around the country have held otherwise. Sections 11 and 14 are analogous—both provide for liability for false statements of “fact”—and there is no reason why the *Virginia*

Bankshares rule would apply to one but not the other (and courts have applied it to both). Plaintiff's cases are inapposite—they did not involve the application of Section 11 to opinions. Because there is little dispute that loan loss reserves and goodwill are matters of opinion, *Virginia Bankshares* compels dismissal of the claim against E&Y.

II. There are also alternative grounds for affirmance, which E&Y asserted in the district court. Wholly independent of *Virginia Bankshares*, the complaint does not state a plausible claim against E&Y: it is based on hindsight, alleging that E&Y should have anticipated at the end of 2007 the changes that Regions would make to its loss reserves and goodwill in early 2009—after the global economy almost collapsed in the fall of 2008. The claim is also barred by the bespeaks caution doctrine: the offering documents were filled with warnings about possible changes in loss reserves and goodwill if the real estate market continued to deteriorate.

ARGUMENT

I. To State A Claim Against E&Y, The Complaint Must—But Does Not—Allege Subjective Falsity.

A. Statements Concerning Loan Loss Reserves And Goodwill Are Opinions.

Plaintiff does not contest the district court's holding (SA10-11, 14) that determining appropriate amounts for loss reserves and goodwill is a matter of

opinion. Indeed, plaintiff notes that “accounting involves matters of judgment and opinion” (Pl. Br. 36), refers to “accounting judgments” and “accounting opinions” (*id.* at 29, 49), and frames the issues on appeal as involving accounting “judgment” (*id.* at 2-3). Elsewhere, however, plaintiff asserts that “objective factors” and “objective facts” show that the loss reserve and goodwill figures in the 2007 10-K were wrong. *Id.* at 20, 47. But he does not cite any cases holding that loss reserves and goodwill are straightforward facts, readily determined by applying generally accepted accounting principles (GAAP). That is because both loss reserves and goodwill involve matters of opinion that are based on predictions about the future.

To begin with, “GAAP is not [a] lucid or encyclopedic set of pre-existing rules”—it “is often indeterminate.” *Shalala v. Guernsey Mem. Hosp.*, 514 U.S. 87, 101 (1995). “Financial accounting is *not a science*. It addresses *many questions* as to which the answers are *uncertain* and is a ‘process [that] involves *continuous judgments and estimates*.’” *Id.* at 100 (emphasis added). There are “19 different GAAP sources, any number of which might present conflicting treatments of a particular accounting question.” *Id.* at 101. As a result, GAAP “tolerate[s] a range of ‘reasonable’ treatments, leaving the choice among alternatives to management.” *Thor Power Tool Co. v. Comm’r*, 439 U.S. 522, 544 (1979).

The highly judgmental matters at issue here, loss reserves and goodwill,

stand apart in terms of the range of possible GAAP treatments, because they are so inherently judgmental and predictive. Indeed, statements concerning loan loss reserves are opinions about what may occur in the future. As explained earlier (at 10-11) and as the complaint acknowledges, loan loss reserves are based on “expectations about future loan losses.” BANKING TERMINOLOGY at 215; see JA1090 ¶ 172 (to calculate its “loss exposure,” Regions was required “to evaluate the likelihood of future cash flows”). By their very nature, loan loss reserves involve “prediction[s],” *Wells*, 1994 WL 228842, at *17, and “guesswork about the future,” which in the case of real estate “depend[] on the economics of the real estate market,” *First Nationwide*, 820 F. Supp. at 95. As a case cited in plaintiff’s brief states, “[t]here appears to be no single method of evaluating and setting loan loss reserves,” which involve “judgments” that “can be validated only at some future date.” *Shapiro v. UJB Fin.*, 964 F.2d 272, 281, 283 (3d Cir. 1992) (affirming the dismissal of allegations that the defendants did not disclose that the bank would have to increase reserves in the future—there is no federal securities liability for “essentially failing to predict the future”). Another case cited by plaintiff agrees that “characterizations of reserves as adequate are necessarily a matter of opinion and belief”—the “estimation of probable losses in a large loan portfolio ... is more an art than a science.” *United States v. Morris*, 80 F.3d 1151,

1163, 1164 (7th Cir. 1996).³

Under accounting principles, setting loan loss reserves is a matter of opinion requiring a substantial amount of judgment. Reserves are increased when a loan is “impaired,” and a loan is not impaired unless it is “probable”—that is, “likely to occur”—that the loan will not be repaid in full. SFAS No. 114 ¶¶ 8, 10 (JA916). “Probable is a higher level of likelihood than ‘more likely than not.’” EITF Topic No. D-80, *Application of FASB Statements 5 and 114 to a Loan Portfolio*, Ex. D-80A, Answer to Question 8.⁴ Accounting principles recognize that “application of the term probable in practice requires judgment” (SFAS No. 114 ¶ 49) and that the “complexity” inherent in determining “expected future cash flows” from loans is “unavoidable” (*id.* ¶ 35).⁵ See also *id.* ¶ 43 (“expected future cash flows from

³ See also *Stephens v. National Distillers & Chem. Corp.*, 6 F.3d 63, 65 (2d Cir. 1993) (insurance loss reserves “are extremely conjectural, and may need adjustment as time passes and their accuracy can be tested in retrospect”); *Belmont Holdings v. SunTrust Banks*, 2010 WL 3545389, at *6 (N.D. Ga. Sept. 10, 2010) (“Whether SunTrust had adequate reserves for its predicted loan losses generally is not a matter of objective fact, but rather a statement of SunTrust’s opinion regarding what portion of its loan portfolio would be uncollectable”); *In re Countrywide Fin. Deriv. Litig.*, 554 F. Supp. 2d 1044, 1070 (C.D. Cal. 2008) (“the setting of loan loss reserves involves a great deal of discretion”).

⁴ EITF Topic No. D-80 is cited in the complaint. *E.g.*, JA1089-91 ¶¶ 169, 174. It may be found at http://www.fasb.org/eitf/Topic_D-80.pdf.

⁵ Part of SFAS No. 114, which is cited in the complaint (*e.g.*, JA1089-90 ¶¶ 169-72), was inadvertently omitted from the exhibits submitted in the district court. The paragraphs quoted in the text that lack JA cites may be found at <http://www.fasb.org/pdf/fas114.pdf>.

impaired loans are usually uncertain and creditors will be required to exercise significant judgment in developing the estimates of expected future cash flows”); EITF Topic No. D-80, Board of Governors of the Federal Reserve System, *Recent Developments Regarding Loan Loss Allowances*, at 3 (“Arriving at an appropriate allowance involves a high degree of management judgment and results in a range of estimated losses”; there is “imprecision inherent in most estimates of expected credit losses”).

Statements concerning goodwill are likewise opinions. The plaintiff concedes that goodwill involves considering what might happen in the future:

Goodwill ... is “considered to be an asset because *future* economic benefits are expected from it in combination with the *future* benefits of the other assets acquired in the acquisition. Goodwill is intended to reflect the going concern value of the business acquired and its expected contribution to *future* earnings growth.”

Pl. Br. 51 (quoting the complaint, JA1081-82 ¶ 146, which in turn cites SFAS No. 141) (emphasis added). See also JA1081 ¶ 144 (“Regions’ reported goodwill vastly overstated the *future benefit* AmSouth would provide”) (emphasis added); SFAS No. 141, ¶ 3(j) (JA940) (“*Goodwill* is an asset representing the *future* economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized”) (emphasis added); JA803 (Regions’ July 2008 letter to the SEC, explaining that it evaluated goodwill impairment using “future cash flow projections” and other factors).

Attributing a value to those future benefits is a matter of opinion that requires exercising considerable judgment and weighing multiple factors. See *Vivendi*, 242 F.R.D. at 81 n.3 (goodwill “reflects the value of intangible assets like reputation, brand name, good customer relations, good employee relations, any patents and proprietary technology, and other intangibles that improve a company’s business”); *In re REMEC Sec. Litig.*, 702 F. Supp. 2d 1202, 1214, 1238 (S.D. Cal. 2010) (“The accounting method to value goodwill involves predictions of future results and other uncertain variables” and “amorphous concepts like the ‘synergy’ created by merging two companies,” which requires “professional judgment”).

Determining whether and when to test for goodwill impairment under SFAS 142 also “necessarily involves judgment and discretion.” *City of Omaha v. CBS*, 2010 WL 1029290, at *10 (S.D.N.Y. Mar. 16, 2010). See SFAS No. 142 ¶¶ 18-25 & n.16 (JA983-85) (determining whether goodwill is impaired requires “estimat[ing]” a company’s “fair value” and considering the “synergies and other benefits that flow from control over another entity”); *Iron Workers v. Oshkosh Corp.*, 2010 WL 1287058, at *23 (E.D. Wis. Mar. 30, 2010) (goodwill “impairment analysis is highly subjective and is based on a number of factors, including the company’s future prospects”); *City of Sterling Heights v. Vodafone*, 655 F. Supp. 2d 262, 269-70 (S.D.N.Y. 2009) (a goodwill impairment charge is

“contingent on the company’s judgment about future events and its likely future income”—“[w]hen the impairments became so severe as to require specific accounting charges, and whether ... the accounting principles were satisfied, necessarily involved issues of judgment”) (quoting *In re Loral Space & Communications Sec. Litig.*, 2004 WL 376442, at *17 (S.D.N.Y. Feb. 27, 2004)). Cf. *In re Salomon Analyst Level 3 Litig.*, 373 F. Supp. 2d 248, 251-52 (S.D.N.Y. 2005) (Lynch, J.) (valuations of a company “can only fairly be characterized as subjective opinions ... and not objective facts”).

Thus, the notion that goodwill is “a line on a graph, on which the precise value of [a company’s] goodwill can be determined at any given moment in time ... bears little relation to reality.” *Harris v. IVAX Corp.*, 998 F. Supp. 1449, 1453 (S.D. Fla. 1998), *aff’d*, 182 F.3d 799 (11th Cir. 1999). “[T]he value of an intangible asset like goodwill is much less exact and depends on numerous other business judgments.” *Id.*

Not only are loss reserves and goodwill matters of opinion, but they reflect the opinion of *the company*, which prepares its own financial statements. AICPA, *Codification of Statements on Auditing Standards*, AU § 110.03 (2009) (JA1001); *Bily v. Arthur Young & Co.*, 834 P.2d 745, 749, 762 (Cal. 1992). An auditor, in turn, audits the financial statements and issues an audit report expressing its own opinion on whether the financial statements—taken as a whole—fairly present the

company's financial position in accordance with GAAP. AU § 110.01 (JA1001); *Bily*, 834 P.2d at 750. See JA413 (E&Y's audit opinion). Rendering that opinion requires the auditor to exercise "complex professional judgment." *Bily*, 834 P.2d at 763.

In sum, the district court correctly held that loan loss reserves and goodwill are matters of opinion. And E&Y's audit opinion on Regions' financial statements is one step removed from Regions' opinions concerning loss reserves and goodwill.

B. Subjective Falsity Allegations Are Required For Section 11 Claims Based On Statements Of Opinion.

1. *Virginia Bankshares* requires subjective falsity to establish a federal securities claim based on an opinion.

Section 11 provides for liability when a registration statement "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). But when the statement at issue is an *opinion*, when is an opinion "an untrue statement of ... fact"?

The answer is provided by *Virginia Bankshares v. Sandberg*, 501 U.S. 1083 (1991), a Section 14 case. Section 14 is similar to Section 11 except that it concerns proxy statements rather than registration statements: a defendant is liable under Section 14 when a proxy statement "contain[s] any statement which, at the

time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading.” 17 C.F.R. § 240.14a-9(a). See *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 372 n.14 (3d Cir. 1993) (*Virginia Bankshares* is “instructive” in addressing Section 11 claims).

The question in *Virginia Bankshares* was whether a company’s directors made a false or misleading statement under Section 14 by recommending shareholder approval of a freeze-out merger because minority shareholders could achieve a “high” value and receive a “fair” price for their stock. 501 U.S. at 1088. A minority shareholder objected to the merger and sued, alleging that the directors “had not believed that the price offered was high or that the terms of the merger were fair, but had recommended the merger only because they believed they had no alternative if they wished to remain on the board.” *Id.* at 1088-89.

The Supreme Court considered “the actionability *per se* of statements of reasons, opinion, or belief,” which “by definition purport[] to express what is consciously on the speaker’s mind.” *Id.* at 1090. The Court “confine[d] [its] discussion” to “statements of belief and opinion” that “were made with knowledge that the directors did not hold the beliefs or opinions expressed.” *Id.* In particular, the Court decided “whether statements of reasons, opinions, or beliefs are

statements ‘with respect to ... material fact[s]’ so as to fall within the strictures of the Rule [14a-9].” *Id.* at 1091.

The Court observed that the directors’ “statements of reasons or beliefs ... are factual in two senses: [1] as statements that the directors do act for the reasons given or hold the belief stated and [2] as statements about the subject matter of the reason or belief expressed.” *Id.* at 1093. The Court held that *both* must exist for there to be Section 14 liability for making a false statement: the plaintiff must establish the defendants’ “disbelief, or undisclosed belief or motivation” *and* provide “objective evidence ... that the statement also expressly or impliedly asserted something false or misleading about its subject matter.” *Id.* at 1095-96. For the first requirement—showing that the statement at issue “misstate[s] the speaker’s reasons”—the Court held that “[a] statement of belief may be open to objection only” if it is “a misstatement of the psychological fact of the speaker’s belief in what he says.” *Id.* at 1095. See *id.* at 1087 (“We hold that knowingly false statements of reasons may be actionable”).

Plaintiff fundamentally misinterprets *Virginia Bankshares*. He argues that establishing the second of the two ways in which statements of belief are factual is sufficient by itself for liability. See Pl. Br. 27, 44-46. But as just discussed, *Virginia Bankshares* held that the first factual sense—the speaker’s “disbelief, or undisclosed belief or motivation”—is *also* required. 501 U.S. at 1095. Plaintiff

acknowledges this at one point: he states that to establish liability, *Virginia Bankshares* requires the defendant’s “subjective disbelief” in a statement *and* “[t]he statement must be objectively misleading *too*.” Pl. Br. 46 (emphasis added). The rest of plaintiff’s brief ignores this concession.

Plaintiff also contends that negligent opinions may be misleading. Pl. Br. 35-36, 44-49. Regardless, that does not mean they are *actionable* under the federal securities laws. The issue here is not whether E&Y’s opinion was misleading; it is whether the plaintiff has alleged a misstatement of “fact,” as Section 11 requires. 15 U.S.C. § 77k(a). *Virginia Bankshares* held that a misleading opinion alone is not a basis for liability; the opinion must also falsely state the speaker’s beliefs:

statements of reasons of the sort exemplified here ... misstate the speaker’s reasons *and also mislead* about the stated subject matter (*e.g.*, the value of the shares). A statement of belief may be open to objection only in the former respect, however, solely as a misstatement of the psychological fact of the speaker’s belief in what he says.

501 U.S. at 1095 (emphasis added). It is only when there is a “misstatement of the psychological fact of the speaker’s belief” (*id.*) that “statements of reasons, opinions, or beliefs are statements ‘with respect to ... material fact[s]’” (*id.* at 1091). See also *id.* at 1108-09 (Scalia, J., concurring) (“As I understand the Court’s opinion, the statement ‘In the opinion of the Directors, this is a high value for the shares’ would produce liability if in fact it was not a high value *and the directors knew that*. It would not produce liability if in fact it was not a high value

but the directors honestly believed otherwise”) (emphasis added). In short, whether an opinion “can be misleading” (Pl. Br. 36) has no bearing on whether it is a statement of fact.⁶

As this Court has summarized, *Virginia Bankshares* holds that “[a] statement of reasons, opinion or belief” is “actionable under the securities laws *if* the speaker *knows* the statement to be false.” *Shields v. Citytrust Bancorp*, 25 F.3d 1124, 1131 (2d Cir. 1994) (emphasis added). A complaint is deficient when “it fails adequately to allege that the expression of the opinions and beliefs was fraudulent.” *Id.* Plaintiff notes that *Shields* is a Section 10(b) case (Pl. Br. 40), but ignores that *Shields* said that *Virginia Bankshares*’ holding on opinions applied to “the securities laws” generally. 25 F.3d at 1131. *Virginia Bankshares* was not a Section 10(b) case. See also *Friedman v. Mohasco Corp.*, 929 F.2d 77, 78-79 (2d Cir. 1991) (pre-*Virginia Bankshares*, holding that allegations concerning an opinion as to securities’ market value did not state a claim under the Securities Act of 1933 or the Securities Exchange Act of 1934, because “there is no allegation” that the defendants “did not hold the joint opinion” on market value).

Judge Lynch has explained the point succinctly: “a material misstatement of *opinion* is by its nature a false statement, not about the objective world, but about

⁶ To draw on an illustration that Judge Kaplan used during one hearing (JA30-31), the statement “I think it will rain in Wichita tomorrow” may mislead a listener—if she relies on it and leaves her umbrella at home—but that does not make it a statement of fact.

the defendant's own belief.” *Podany v. Robertson Stephens, Inc.*, 318 F. Supp. 2d 146, 154, *motion to amend denied*, 350 F. Supp. 2d 375 (S.D.N.Y. 2004). To prove that an opinion is false “is the same as proving scienter, since the statement (unlike a statement of fact) cannot be false at all unless the speaker is knowingly misstating his truly held opinion.” *Id.* at 153-54 (holding that under *Virginia Bankshares* “[t]he *sine qua non* of a securities fraud claim based on false opinion is that defendants deliberately misrepresented a truly held opinion”; plaintiffs must allege “that defendants did not sincerely believe the opinion they purported to hold”). Accord *In re Credit Suisse First Boston*, 431 F.3d 36, 48 (1st Cir. 2005); *In re Salomon Analyst Level 3 Litig.*, 350 F. Supp. 2d 477, 490 (S.D.N.Y. 2004) (Lynch, J.), *reconsideration denied*, 373 F. Supp. 2d 248, 251-52 (S.D.N.Y. 2005).

2. Courts have held that *Virginia Bankshares*' subjective falsity requirement applies to Section 11 claims based on opinions.

In Section 11 cases involving allegedly false opinions, courts have applied *Virginia Bankshares* and held that the plaintiff must allege “that the statements were both objectively and subjectively false or misleading” in order to state a claim. *Rubke v. Capitol Bancorp*, 551 F.3d 1156, 1162 (9th Cir. 2009) (affirming dismissal of a Section 11 claim based on a fairness opinion because the complaint “fails to allege” that the defendants “believed the deal offered ... was unfair”). As the First Circuit stated recently in affirming the dismissal of Section 11 claims

based on investment ratings for securities, “[d]efendants are not liable under the securities laws when their opinions ... were honestly held when formed but simply turn out later to be inaccurate; nor are they liable only because they could have formed ‘better’ opinions.” *Plumbers’ Union v. Nomura Asset Accept. Corp.*, ___ F.3d ___, 2011 WL 183971, at *9 (1st Cir. Jan. 20, 2011). See also *In re Global Crossing Sec. Litig.*, 313 F. Supp. 2d 189, 210-11 (S.D.N.Y. 2003) (Lynch, J.) (“Materially misleading statements of opinion and belief can be actionable under the securities laws, where the party offering the opinion misrepresents its true belief, that is, where the opinion or belief is not truly held”) (dismissing a Section 11 claim based on a fair value opinion); *In re AOL Time Warner, Inc. Sec. Litig.*, 381 F. Supp. 2d 192, 243 (S.D.N.Y. 2004) (“the plaintiff must show both that the [defendants] did not actually hold the belief or opinion stated, and that the opinion stated was in fact incorrect”) (dismissing a Section 11 claim concerning a fairness opinion); *Freedman v. Value Health*, 958 F. Supp. 745, 752-53 (D. Conn. 1997) (to state a Section 11 claim based on a fairness opinion, *Virginia Bankshares* requires subjective falsity allegations).⁷ Courts have specifically agreed with Judge

⁷ Accord *Tsereteli v. Residential Asset Securitization Trust*, 692 F. Supp. 2d 387, 393-95 (S.D.N.Y. 2010); *In re Lehman Bros. Sec. Litig.*, 684 F. Supp. 2d 485, 494-95 (S.D.N.Y. 2010); *New Jersey Carpenters Vacation Fund v. Royal Bank of Scotland*, 720 F. Supp. 2d 254, 271-72 (S.D.N.Y. 2010); *Stumpf v. Garvey*, 2005 WL 2127674, at *17 (D.N.H. Sept. 2, 2005).

Plaintiff suggests that *Lehman* and *Tsereteli* cited only *Shields*, a Section

Kaplan's decision in this case. See *In re Barclays Bank Sec. Litig.*, 2011 WL 31548, at *8 (S.D.N.Y. Jan. 5, 2011); *Belmont Holdings*, 2010 WL 3545389, at *6.

In particular, *Virginia Bankshares*' subjective falsity requirement has been the basis for dismissing a Section 11 claim concerning an opinion that a bank's loan loss reserves were "appropriate and adequate." *Belmont Holdings*, 2010 WL 3545389, at *1, 6 ("Plaintiff does not allege that SunTrust did not actually hold the opinion it expressed in its financial statements at the time they became effective"). See also *Ciresi v. Citicorp*, 782 F. Supp. 819, 822-23 (S.D.N.Y. 1991) (not citing *Virginia Bankshares*, but dismissing a Section 11 claim because statements of "predictions or opinions" about loan loss reserves "do not constitute material misrepresentations or omissions of fact") (emphasis added), *aff'd*, 956 F.2d 1161 (2d Cir. 1992) (table).⁸

Similarly, cases involving opinions brought under Section 14—which like Section 11 must be based on a statement of "fact," 17 C.F.R. § 240.14a-9—hold that a complaint must allege the defendant's subjective falsity to state a claim. See *City of St. Clair v. Inland Western*, 635 F. Supp. 2d 783, 793 (N.D. Ill. 2009)

10(b) case. See Pl. Br. 40-41, 50. Not so. Both opinions also cited *Virginia Bankshares* and Judge Lynch's Section 11 opinion in *Global Crossing. Lehman*, 684 F. Supp. 2d at 494 n.48; *Tsereteli*, 692 F. Supp. 2d at 393 n.43.

⁸ Plaintiff (at 41) misdescribes *Ciresi*'s Section 11 holding as being based on standing. That was the *second* reason for dismissing the Section 11 claim, "[i]n addition" to the ruling described in the text. 782 F. Supp. at 822-23.

(applying this standard to allegations concerning an auditor's reports); *Lane v. Page*, 581 F. Supp. 2d 1094, 1126-27 (D.N.M. 2008); *In re McKesson HBOC Sec. Litig.*, 126 F. Supp. 2d 1248, 1264-65 (N.D. Cal. 2000); *Bond Opportunity Fund v. Unilab Corp.*, 2003 WL 21058251, at *5 (S.D.N.Y. May 9, 2003), *aff'd*, 87 F. App'x 772 (2d Cir. 2004) (summary order).

3. Plaintiffs' authorities do not support his argument.

Plaintiff cites no contrary cases under Section 11 or Section 14. Instead, he argues at length that because there is so-called presumptive liability under Section 11 for accountants, and because the statute does not explicitly require scienter, subjective falsity allegations are not needed. Pl. Br. 29-43. The cases plaintiff cites affirmatively are irrelevant. None of them involved an argument that the defendant had misstated its *opinion* and that therefore *Virginia Bankshares* requires subjective falsity.⁹ (Moreover, some of the cases, including *Republic Tech. Fund v. Lionel Corp.*, 483 F.2d 540 (2d Cir. 1973), were decided long before *Virginia Bankshares*.) Accordingly, plaintiff's cases are not precedent on the issue in this case. “Questions which merely lurk in the record, neither brought to the attention of the court nor ruled upon, are not to be considered as having been so

⁹ The reference in *In re Citigroup Bond Litig.*, 723 F. Supp. 2d 568, 594 (S.D.N.Y. 2010) (cited Pl. Br. 38-39), to a “subjective view” of how GAAP should be applied referred to the defendants' argument there that the plaintiffs alleged fraud by hindsight. Those defendants did not cite *Virginia Bankshares* or argue that they had made statements of opinion that required plaintiffs to allege subjective falsity. See 2009 WL 1618226 (defendants' brief).

decided as to constitute precedents.’” *Cartoon Network v. CSC*, 536 F.3d 121, 129 (2d Cir. 2008).

Plaintiff argues (at 42) that the “[a]bsence of a reasonable basis” for an opinion is enough to state a claim, relying on this Court’s statement in a Section 10(b) case that predictions about future payment of dividends “may be actionable ... if the speaker does not genuinely or reasonably believe them.” *In re IBM Sec. Litig.*, 163 F.3d 102, 107 (2d Cir. 1998). That case does not support plaintiff’s position.

First, *IBM*—which did not cite *Virginia Bankshares*—was discussing materiality, not whether subjective falsity was required for a statement of opinion to be a statement of fact; it certainly did not involve the opinion of an accounting firm on highly judgmental matters in a financial statement. *Id.* at 107. And the Court noted that a plaintiff must show that the false statements were made “with scienter.” *Id.* at 106. Second, if the absence of a “reasonable” belief for an opinion sufficed to state a claim, that would be squarely inconsistent with *Virginia Bankshares*, which held that an opinion is not actionable under the federal securities laws unless it was both subjectively and objectively false. See pp. 23-28, *supra*; *McGuire v. Dendreon Corp.*, 688 F. Supp. 2d 1239, 1241-44 (W.D. Wash. 2009) (explaining that *Virginia Bankshares* effectively overruled *In re Apple Computer Sec. Litig.*, 886 F.2d 1109 (9th Cir. 1989), which *IBM* relied on for this

point, 163 F.3d at 107, 109). Under *Virginia Bankshares*,

[i]t is *not sufficient ... to allege that an opinion was unreasonable, irrational, excessively optimistic, not borne out by subsequent events, or any other characterization that relies on hindsight or falls short of an identifiable gap between the opinion publicly expressed and the opinion truly held.*

Salomon, 350 F. Supp. 2d at 489 (emphasis added). See also *Stumpf*, 2005 WL 2127674, at *15 n.20; *Freedman*, 958 F. Supp. at 752-53; *McKesson*, 126 F. Supp. 2d at 1265. Third, *IBM* is not as clear as plaintiff suggests: the Court stated elsewhere in its opinion that the plaintiff must establish that the defendants did not genuinely *and* reasonably believe the false statements. The Court affirmed summary judgment for the defendants because “there is no evidence in the record to support a finding that these statements were made in bad faith or that the speakers did not genuinely and reasonably believe that they were accurate.” 163 F.3d at 109; see also *id.* at 110 (the challenged statements “were true expressions of IBM’s view at the time”).

Plaintiff contends that a defendant’s state of mind is relevant only to Section 11’s affirmative defense of good faith, 15 U.S.C. § 77k(b)(3)(B), and that a plaintiff is not required to plead facts to avoid that defense. Pl. Br. 32-33. But alleging a false statement of “fact” clearly is part of a plaintiff’s burden. 15 U.S.C. § 77k(a). Without it, there is no Section 11 violation. And as we have shown, an opinion is not “an untrue statement of ... fact” (*id.*) unless the defendant did not

believe its opinion at the time it was given. Whether the defendant provided a false opinion at a specified time is different from whether it had a reasonable basis to believe its opinion was correct on that date; the former is an element of a Section 11 claim (not pled here), while the latter concerns a potential affirmative defense. And the affirmative good faith defense will apply to many statements that are misstatements of fact.

Plaintiff further asserts (at 34-35) that Section 11 should not be construed to require subjective falsity for statements of opinion, because another securities statute provides that, for false forward-looking statements included in a financial statement, actual knowledge of the statement's falsity is not required. See 15 U.S.C. § 77z-2(b)(2)(A), (c)(1)(B)(i). But the statute reiterates that “an untrue statement of a material *fact*” is required for liability. 15 U.S.C. § 77z-2(c)(1) (emphasis added). As already shown, an opinion is an untrue statement of fact only if the defendant did not genuinely believe it.

* * *

Despite plaintiff's promise to “plead fraud” with “particularity” (JA31), the complaint does not allege fraud—it does not allege that E&Y did not truly believe its audit opinion at the time. In fact, the complaint “expressly excludes and disclaims any allegation that could be construed as alleging fraud or intentional or reckless misconduct.” JA1106 ¶ 230. Nor are there any allegations that E&Y

subjectively believed that loan loss reserves were understated or that goodwill was overstated. Consequently, if the Court agrees that *Virginia Bankshares* requires subjective falsity allegations, it should affirm dismissal of the claim against E&Y.

II. Even If Subjective Falsity Allegations Were Not Required, The Complaint Does Not State A Plausible Claim Against E&Y.

Even if *Virginia Bankshares* did not require allegations of subjective falsity, the complaint does not state a claim against E&Y for an independent reason: it does not allege “enough facts to state a claim to relief that is plausible on its face.” *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007). A claim has “facial plausibility” only “when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.” *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009). But when a complaint “stops short of the line between possibility and plausibility of ‘entitle[ment] to relief’” (*Twombly*, 550 U.S. at 557)—that is, where a claim is merely “‘conceivable’” and “‘the well-pleaded facts do not permit the court to infer more than the mere possibility of misconduct’”—the complaint must be dismissed. *Iqbal*, 129 S. Ct. at 1950-51 (quoting *Twombly*, 550 U.S. at 570). For many reasons, the complaint does not state a plausible claim against E&Y.

A. The Complaint Does Not Allege A Plausible Claim That There Were Material Misstatements Of Then-Existing Fact In The 2007 Financial Statements.

Plaintiff’s theory is that the 2007 financial statements violated GAAP

because they falsely understated loan loss reserves by at least \$1 billion and overstated goodwill from the AmSouth acquisition by at least \$6 billion, the same amounts by which Regions increased reserves and decreased goodwill in January 2009—after a near economic meltdown in the fall of 2008, the worst economic crisis since the Great Depression. See JA1026-27 ¶¶ 12, 14; JA1034-35 ¶ 27; JA1073 ¶ 129; JA1079 ¶ 139; JA1085 ¶ 158. Plaintiff alleges that the facts that caused the January 2009 changes existed in December 2007. JA1073 ¶ 129; JA1079 ¶ 139; JA1085 ¶ 158.

Plaintiff pretends that the events during the latter half of 2008 played no role in Regions' January 2009 changes, but Regions' announcement of those changes (which the complaint cites, JA1072 ¶ 126) noted the impact of recent events:

Continued declines in housing and residential-related construction project values, as well as rising unemployment, necessitated the [loan loss] reserve increase. Prices of Florida-based properties remain under particular pressure, with the real estate downturn rippling through the economy and propelling unemployment levels.

JA1008. Indeed, by January 2009, Florida's unemployment rate had shot up to 8.6%, a steep rise from only 5% in January 2008. S. FLA. BUS. J. Mar. 6, 2009 (available at www.southflorida.bizjournals.com). Nonetheless, plaintiff insists—with the enviable luxury of hindsight—that E&Y should have known at the end of 2007 that 2008 would be much worse than anticipated and that Regions was wrong at year-end 2007 in forecasting its future business prospects when determining its

goodwill and loan loss reserves—which Regions increased in 2007 by nearly 400% over 2006, to \$555 million. See JA361. (The complaint calls this a “marginal[] increase[.]” JA1025 ¶ 10.) Plaintiff’s theory is full of holes.

1. An auditor has no duty to warn of business trends.

As an initial matter, plaintiff misunderstands an auditor’s role. An auditor reviews the company’s financial information as of a specific point in time; an auditor does not make predictions about the company’s future business prospects. As a result, an “auditor is not hired to assess the supply and demand conditions facing the audited firm”; there is “no merit” to claims that an audit “report failed to warn [the client] of ominous trends in the [client’s] business.” *Fehribach v. Ernst & Young LLP*, 493 F.3d 905, 910-11 (7th Cir. 2007). An auditor “could not have been expected to know more about trends in the [client’s] business than [the client].” *Id.* at 911. Judge Posner explained in *Fehribach*:

[P]redicting [the client’s] future cash flow on any basis other than the financial statements for the audit year ... was not the function of the audit report. ... “[A]n auditor’s duty is not to give business advice; it is merely to paint an accurate picture of the audited firm’s financial condition, insofar as that condition is revealed by the company’s books and inventory and other sources of an auditor’s opinion.”

Id. at 910 (quoting *Johnson Bank v. George Korbakes & Co.*, 472 F.3d 439, 443 (7th Cir. 2006)).

2. Plaintiff’s claims are based on hindsight.

Moreover, because a Section 11 claim “must” be based on “information

[that] existed at the time the registration statement became effective,” events that occurred after that date “cannot be a basis for relief under that section.” *Rubke*, 551 F.3d at 1164. Plaintiff, however, relies extensively on events that took place *after* E&Y’s audit report on the 2007 financial statements and the April 2008 offering, including events affecting the American economy in the summer and fall of 2008, Regions’ acceptance of TARP funds in October 2008, articles written in the fall of 2008, and Regions’ January 2009 announcement that it was increasing its loan loss reserves and decreasing the amount attributed to goodwill. See Pl. Br. 13, 20-25, 54-62 (citing many post-April 2008 allegations: JA1027 ¶ 15; JA1062 ¶¶ 111-12; JA1064-69 ¶¶ 114-17, 119-23; JA1071-73 ¶¶ 125-27, 131; JA1075-78 ¶¶ 135-36; JA1085 ¶ 157; JA1086 ¶ 160; JA1093-94 ¶ 184).

This is “pleading with 20/20 hindsight.” *Panther Partners v. Ikanos Communications*, 538 F. Supp. 2d 662, 669 (S.D.N.Y. 2008), *reconsideration denied*, 2008 WL 2414047 (S.D.N.Y. June 12, 2008), *aff’d in part and vacated in part on other grounds*, 347 F. App’x 617 (2d Cir. 2009) (summary order). That is impermissible because “even the most exhaustively researched predictions are fallible.” *Olkey v. Hyperion 1999 Term Trust*, 98 F.3d 2, 8 (2d Cir. 1996). “The securities laws do not require clairvoyance in the preparation of offering documents,” which “are not guarantees” against the “vicissitudes” and “volatility” of business. *Panther Partners*, 538 F. Supp. 2d at 664. That is especially true with

respect to the economy in recent years. “[M]any” financial institutions were “floored by the housing market crisis” and “could not have been expected to anticipate the crisis with the accuracy Plaintiff[s] enjoy[] in hindsight.” *In re Security Capital Assurance Sec. Litig.*, 2010 WL 1372688, at *26 (S.D.N.Y. Mar. 31, 2010).

For these reasons, defendants “cannot be subject to liability under the securities laws for their failure to predict in the IPO documents facts that occurred or patterns that were discerned after the IPO.” *In re Adams Golf Sec. Litig.*, 176 F. Supp. 2d 216, 238 (D. Del. 2001) (dismissing Section 11 claim), *aff’d in part and rev’d in part on other grounds*, 381 F.3d 267 (3d Cir. 2004). “[T]he fact that looking backward, one perceives a trend does not necessarily mean that conditions were such that one year earlier the situation was sufficiently obvious.” *Adams Golf*, 381 F.3d at 279. In fact, Regions *did* warn in its 2007 10-K that losses on real estate loans might well increase in 2008 (see pp. 52-53, *infra*); accordingly, it increased its loan loss reserves in 2007 by almost 400%. It just did not know that 2008 would nearly bring the entire economy to its knees and that its losses on real estate loans would be higher than it projected. A prediction is not false simply because it does not come to pass. Accordingly, plaintiff has not alleged a misstatement of material fact that existed at the time.

Nor is it permissible “to assume that Defendants *must* have known because

something did in fact occur later.” *Panther Partners*, 538 F. Supp. 2d at 673. See *Denny v. Barber*, 576 F.2d 465, 467, 470 (2d Cir. 1978) (Friendly, J.) (a claim concerning, *inter alia*, “amounts reserved for loan losses” alleges “fraud by hindsight”; “plaintiff has simply seized upon disclosures made in later annual reports and alleged that they should have been made in earlier ones”).

For example, in *Bay Harbour Mgmt. v. Carothers*, 282 F. App’x 71 (2d Cir. 2008) (summary order), *aff’g Xerion Partners I v. Resurgence Asset Mgmt.*, 474 F. Supp. 2d 505 (S.D.N.Y. 2007) (Chin, J.), the plaintiff alleged that an accounting firm and other defendants must have known, at the time of a debt offering, that the company’s goodwill was inaccurately valued, because a “‘massive write-down[]’” of goodwill occurred five months later. *Id.* at 75. This Court held that this was “nothing more than a ‘fraud by hindsight’ theory, which we have held is not actionable in this Circuit.” *Id.* Similarly, in dismissing a Section 11 claim in *In re CIT Group Sec. Litig.*, 349 F. Supp. 2d 685 (S.D.N.Y. 2004), the court rejected the argument “that defendants could not have actually believed that loan loss reserves were adequate ... because defendants decided to increase loan loss reserves just three weeks after the IPO.” *Id.* at 690. “That defendants later decided to revise the amount of loan loss reserves ... provides absolutely no reasonable basis for concluding that defendants did not think reserves were adequate at the time.” *Id.* at

690-91.¹⁰

3. The complaint’s allegations do not indicate a violation of the judgmental accounting principles cited in the complaint.

The complaint alleges that two accounting principles—SFAS Nos. 114 and 5—obligated Regions to increase its loss reserves, because Regions’ “residential homebuilder portfolio” was allegedly “impair[ed].” JA1089 ¶ 169; see JA 1089-92 ¶¶ 170-79. The alleged understatement of reserves and impairment of Regions’ loans, in turn, purportedly caused Regions’ goodwill to be overstated. JA1026 ¶ 12; JA1079 ¶ 139; JA1081 ¶ 144; JA1084 ¶ 153.

The two accounting principles cited in the complaint are closely related but apply to different categories of loans: SFAS No. 114 applies to loans “that are specifically identified for evaluation” and “may be individually impaired,” while SFAS No. 5 applies to loans “that are not impaired individually” but “may have

¹⁰ See also *Zirkin v. Quanta Capital Holdings*, 2009 WL 185940, at *10-11 (S.D.N.Y. Jan. 23, 2009) (a loss estimate was not false when made simply because it increased 15% two months later); *Coronel v. Quanta Capital Holdings*, 2009 WL 174656, at *14 (S.D.N.Y. Jan. 26, 2009) (same); *In re Fannie Mae 2008 Sec. Litig.*, 2010 WL 3825713, at *20 (S.D.N.Y. Sept. 30, 2010) (a “massive increase” in reserves in the fourth quarter of 2008 does not indicate that reserves were inadequate in August 2007); *Scibelli v. Roth*, 2000 WL 122193, at *3 (S.D.N.Y. Jan. 31, 2000) (it is not reasonable “[t]o infer that Nortel possessed such information [about declining revenue growth] on July 24 because Nortel announced such information on September 29”); *In re Starter Corp. Sec. Litig.*, 1996 WL 406624, at *3 (S.D.N.Y. July 19, 1996) (dismissing a Section 11 claim based on an inventory markdown 18 months after the registration statement, because “[n]o possible inference can be drawn from these write-downs, occurring long after the prospectus, that the questioned statements in the prospectus about inventory controls were false”).

specific characteristics” indicating “it is probable that a group of similar loans includes some losses even though the loss could not be identified with a specific loan.” EITF Topic No. D-80, Board of Governors of the Federal Reserve System, *Recent Developments Regarding Loan Loss Allowances*, at 4 (quoted in complaint, JA1091 ¶ 174). Both provisions require the exercise of a considerable degree of judgment and subjectivity in applying accounting principles. The complaint’s factual allegations do not allege a violation of either one.

a. SFAS No. 114.

SFAS No. 114 governs loans “that are individually deemed to be impaired.” EITF Topic No. D-80, *Application of FASB Statements 5 and 114 to a Loan Portfolio*, Ex. D-80A, Answer to Question 1. Under SFAS No. 114, an individual loan is not “impaired” unless “it is probable”—based on “current” information—that the bank “will be unable to collect all amounts due according to the contractual terms of the loan agreement.” JA1089 ¶ 169 (quoting SFAS No. 114 ¶ 8, JA916). Thus, whether to increase reserves under SFAS No. 114 necessarily depends on the circumstances of a bank’s particular loans—it requires information that a particular loan will probably not be repaid in the future. The complaint, however, lacks any allegations about specific loans in Regions’ portfolio in 2007. Nor does the complaint provide any specifics about the impact of problems in the Florida real estate market on Regions’ particular loans.

Consistent with SFAS No. 114, courts require allegations about particular loans for claims that problems with a bank's loans required increasing reserves or decreasing goodwill. In *Denny*, a suit against a bank and its auditor, plaintiffs challenged "the amounts reserved for loan losses," claiming some loans "had become 'increasingly risky.'" 576 F.2d at 467. Judge Friendly held that the allegations were insufficient because "there is no specification of what loans, at what times, and in what amounts were 'risky.'" *Id.* at 469. Similarly, *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir. 1990), followed *Denny* in affirming the dismissal of a claim against an auditor based on allegations that a bank—which understated credit losses by \$4 billion—"did not increase its reserves fast enough." *Id.* at 626-27. The complaint was deficient because it did "not ... give examples of problem loans that E&W should have caught, or explain how it did or should have recognized that the provisions for reserves established by [the bank] were inaccurate." *Id.* at 626. See also *Lerner v. FNB*, 841 F. Supp. 97, 102-03 (W.D.N.Y. 1993) (because "*details* about specific delinquent loans" are "[n]oticeably absent," the complaint does not show why "defendants *must have known* that loan loss reserves were inadequate").¹¹

¹¹ In arguing that his claims are plausible, plaintiff relies on some cases that do not involve a bank's loans, and therefore are inapposite. See Pl. Br. 51-52, 55-56. Of the other cases that plaintiff cites (*id.* at 58-59, 62), *Morris*, 80 F.3d at 1163-65, and *Shapiro*, 964 F.2d at 281-83, hold that *Virginia Bankshares* applies to statements about loan loss reserves, requiring subjective falsity allegations.

Allegations about particular loans are likewise required for claims that goodwill was impaired due to poor loans. See *Sterling Heights*, 655 F. Supp. 2d at 270 (complaint does not allege “which *specific losses known* to the Company should have triggered an impairment charge”) (emphasis added); *Rosen v. Textron*, 321 F. Supp. 2d 308, 326-27 (D.R.I. 2004) (complaint does not “set forth in sufficient detail facts showing” that company knew 11 months earlier that writing down goodwill was required); *In re Corning Sec. Litig.*, 2004 WL 1056063, at *31-32 (W.D.N.Y. Apr. 9, 2004) (dismissing claim based on timing of \$5.1 billion goodwill write-down: without allegations of “specific facts,” the court could not “conclude that defendants unreasonably delayed in writing down inventories and

Citigroup, 723 F. Supp. 2d at 575, involved a bank whose reserves covered only “losses that had already occurred,” rather than losses likely to occur in the future. There is no such allegation here.

Furthermore, plaintiff is dead wrong in asserting (at 59) that “the complaint alleges facts similar to those alleged in *Serabian* and *Wells Fargo*.” *In re Wells Fargo Sec. Litig.*, 12 F.3d 922 (9th Cir. 1993), reversed the dismissal of claims concerning loss reserves because that complaint—unlike here—identified nine specific “bad loans” to particular borrowers that caused the reserves to be understated by \$350 million. *Id.* at 926; see also *id.* at 928 (distinguishing *Denny* and *DiLeo* on this basis). In *Serabian v. Amoskeag Bank Shares*, 24 F.3d 357 (1st Cir. 1994), the complaint—again, unlike here—alleged contemporaneous facts showing “a contrast between what company officials were hearing internally about their loan review effectiveness and the adequacy of their [allowance for loan losses], and what the company was telling the public *at the same time*.” *Id.* at 365 (emphasis by court); see also *id.* at 364 n.9 (contemporaneous admission by bank vice president that he “did not believe that his department was devoting an adequate amount of time to the monitoring of the appropriateness of credit quality ratings”).

goodwill figures because, as it developed, the downturn in the telecommunications market was more severe than analysts had predicted at the end of 2000”), *aff’d*, 2005 WL 714352 (2d Cir. Mar. 30, 2005) (summary order).

b. SFAS No. 5.

The other accounting principle on loss reserves at issue, SFAS No. 5, applies to loss reserves for loans that, while not individually impaired, may have characteristics indicating probable losses. Under SFAS No. 5, a loss contingency is accrued if loans “have specific characteristics that indicate that there would be probable loss in a group of loans with those characteristics” (JA1090-91 ¶ 174) and the “amount of loss can be reasonably estimated” (SFAS No. 5 ¶ 8(b)).¹² Any accrual under SFAS No. 5 must be based on “information available prior to the issuance of the financial statements” that indicates probable impairment “at the date of the financial statements.” *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, at 3 n.7 (2006).¹³

Although SFAS No. 5 does not require individual impairment, the circumstances of a bank’s particular loans are still relevant in deciding whether to

¹² SFAS No. 5 is cited in the complaint (JA1091 ¶ 175; JA1092 ¶¶ 178-79); it may be found at <http://www.fasb.org/pdf/fas5.pdf>.

¹³ The *Interagency Policy Statement*, which discusses SFAS Nos. 5 and 114 in detail, was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, the National Credit Union Administration, and the Office of Thrift Supervision. It may be found at <http://www.federalreserve.gov/boarddocs/srletters/2006/SR0617a1.pdf>.

increase reserves: accrual of “loss contingencies should be based on an evaluation of the facts in each particular case,” and “[w]hether the amount of loss can be reasonably estimated” will normally depend on, among other things, “information about the ability of individual debtors to pay.” SFAS No. 5 ¶¶ 21, 23. Thus, as with SFAS No. 114, the complaint’s failure to allege any facts about particular Regions’ loans means that there is no basis for inferring a violation of SFAS No. 5.

Furthermore, losses cannot be accrued under SFAS No. 5 due to general economic conditions: “[g]eneral ... business risks do not meet the conditions for accrual in paragraph 8, and no accrual for loss shall be made.” SFAS No. 5 ¶ 14. The complaint, however, rests entirely on allegations of general business risks: it is filled with allegations about Florida real estate generally, the state of the economy, and the overall level of Regions’ loss reserve. See Pl. Br. 12-14, 17, 54-62 (citing JA1024-25 ¶¶ 7, 9; JA1047-50 ¶¶ 74-83; JA1052-56 ¶¶ 86, 88, 90-91, 93-95, 97, 101; JA1058 ¶ 103; JA1060 ¶ 108; JA1062 ¶ 112; JA1065-66 ¶¶ 115-17; JA1084-86 ¶¶ 155, 158, 160). But the complaint offers no factual basis for alleging that Regions’ reserve in the aggregate was wrong as of year-end 2007: it does not allege any contemporaneous facts showing that the reserves were misstated based on what was known at the time. The complaint’s allegations about the real estate market generally and the overall economy—especially its heavy reliance on post-April 2008 events—do not provide a basis for concluding that Regions’ financial

statements were false as of the end of 2007. See *Landmen Partners v. Blackstone Group*, 659 F. Supp. 2d 532, 545-46 (S.D.N.Y. 2009) (dismissing a Section 11 claim because “generalized allegations that problems brewing in the [real estate] market at large made it ‘foreseeable’ that a particular set of unidentified investments would sour are insufficient to ‘nudge[] [the] claims across the line from conceivable to plausible’”); *Hinerfeld v. United Auto Group*, 1998 WL 397852, at *7 (S.D.N.Y. July 15, 1998) (dismissing a Section 11 claim about inadequate loss reserves because “[t]here are no facts alleged to support an inference that this failure was the result of anything but inaccurate forecasting or unforeseen circumstances”).¹⁴

Allegations about general market conditions do not permit a “reasonable inference that the defendant is liable for the misconduct alleged.” *Iqbal*, 129 S. Ct. at 1949. Indeed, if general allegations about the real estate market sufficed, a Section 11 claim could be stated against every bank and auditor in the country given the state of the economy in recent years. That would be absurd. See *Iron Workers*, 2010 WL 1287058, at *17 (if “disappointing figures from the future” were “evidence of fraud in the past ..., we would have to conclude that almost

¹⁴ A “significant adverse change ... in the business climate” requires testing goodwill for impairment if the circumstances at the time would likely “reduce the fair value of a reporting unit below its carrying amount.” JA986 ¶ 28 (quoted in part at Pl. Br. 52). But as already discussed (at 37-40), plaintiff’s allegations that the financial statements were false as of year-end 2007 are based on pure hindsight, which is insufficient as a matter of law.

every company in the fall of 2008 was run by fraudsters because their predictions would have been knocked down by the dramatic recession that ensued”) (dismissing goodwill impairment claim against auditor).

4. A gap between a stock’s book value and the company’s market valuation does not indicate goodwill impairment.

Plaintiff asserts that Regions’ goodwill was impaired because, at year-end 2007 and in mid-2008, goodwill exceeded the company’s stock value. Pl. Br. 13, 42, 47, 54. But the argument that “a gap between book value and market capitalization” requires “impairment testing lacks support in the text of SFAS 142 and in relevant caselaw.” *City of Omaha*, 2010 WL 1029290, at *9, 12 (dismissing a goodwill impairment claim based on a \$3.2 billion difference between book value and market capitalization). Such a bright-line test “could make a company potentially liable for securities fraud based on an unexpected dip in its share price.” *Id.* at *9.

In addition, when the SEC raised a question about this precise issue in June 2008—some two months after the April 2008 offering at issue—(a) Regions responded that it *had* tested for goodwill impairment in the fourth quarter of 2007 and the second quarter of 2008; (b) Regions explained why it had concluded that its goodwill was not impaired; and (c) the SEC was evidently satisfied with Regions’ answer. See JA796-97, 803-04; pp. 14-15, *supra*. Plaintiff never explains why it was wrong for E&Y to agree with the SEC, nor does he mention

that the SEC did *not* require Regions to restate or amend its financial statements.

5. Plaintiff's claim is based on non-actionable business judgment.

Finally, “[f]or any bad loan the time comes when the debtor’s failure is so plain that the loan is written down or written off. No matter when a bank does this, someone may say that it should have acted sooner.” *DiLeo*, 901 F.2d at 627. When “all that is involved is a dispute about the timing of the writeoff,” the allegations amount to a claim of poor business judgment, which is not actionable. *Id.* (citing *Santa Fe Industries v. Green*, 430 U.S. 462 (1977)). See also *Ciresi*, 782 F. Supp. at 821 (“the claim that the defendants did not plan their loan reserves properly is essentially a claim that defendants mismanaged the company,” which is “not actionable”); *Hinerfeld*, 1998 WL 397852, at *7 (same); *Naye v. Boyd*, 1986 WL 198, at *4 (W.D. Wash. Oct. 20, 1986) (same; dismissing a claim against an auditor that a bank’s financial statements were false and misleading as to the bank’s loan loss reserves).

* * *

The allegations here do not “plausibly give rise to an entitlement to relief” against E&Y. *Iqbal*, 129 S. Ct. at 1950. The complaint offers no ground for inferring that E&Y should have known, at year-end 2007, that the adjustments made in January 2009—after that near-meltdown of the economy—were already

warranted. An inability to predict the future does not violate the securities laws.¹⁵

B. The Bespeaks Caution Doctrine Bars The Claim Against E&Y.

There is another reason why the claim against E&Y is facially implausible: plaintiff's allegations ignore the explicit warnings contained in Regions' 2007 10-K. Under the common law bespeaks caution doctrine, "alleged misrepresentations in a stock offering are immaterial as a matter of law [if] it cannot be said that any reasonable investor could consider them important in light of adequate cautionary language set out in the same offering." *Rombach v. Chang*, 355 F.3d 164, 173 (2d Cir. 2004) (applying the doctrine to cautionary statements about the future

¹⁵ Besides alleging that Regions' 2007 financial statements violated GAAP, plaintiff alleges that E&Y did not follow GAAS in performing its audit. JA1097 ¶ 192; JA1101-03 ¶¶ 209, 212, 214. If, as we have shown, there is no GAAP violation, then plaintiff's claim fails and it is irrelevant whether the audit complied with GAAS. See *In re Williams Sec. Litig.*, 496 F. Supp. 2d 1195, 1286 (N.D. Okla. 2007).

In addition, the allegations concerning GAAS are deficient because the complaint does not contain any factual allegations to back up its conclusory claim that E&Y did not follow GAAS in performing its audit. JA1097 ¶ 192; JA1101-03 ¶¶ 209, 212, 214. Thus, the complaint does not allege what E&Y should have done in auditing the 2007 financial statements that it did not do, nor does it allege what "evidential matter" and "red flags" (JA1102-03 ¶¶ 212, 214) E&Y supposedly ignored during its audit. The complaint contains many paragraphs concerning E&Y's alleged responsibility under AU § 711 (JA1014-18) to update certain financial information between December 31, 2007 (the date on the 2007 financial statements) and April 28, 2008 (the date of the registration statement). See JA1097-1101 ¶¶ 193-204, 209. But it does not allege any facts showing that E&Y failed to follow the procedures suggested in § 711. In sum, the complaint does not allege "sufficient factual matter" to state a plausible claim that E&Y's audits violated GAAS. *Iqbal*, 129 S. Ct. at 1948.

performance of new acquisitions) (quoting *Halperin v. eBanker USA.com*, 295 F.3d 352, 357 (2d Cir. 2002)). The doctrine “is aimed at warning investors that bad things may come to pass—in dealing with the contingent or unforeseen future.” *P. Stolz Family Partnership v. Daum*, 355 F.3d 92, 97 (2d Cir. 2004). A defendant is not liable if the cautionary language “warns of the specific contingency that lies at the heart of the alleged misrepresentation.” *Id.* The doctrine applies to forward-looking statements, but not to statements of “present or historical fact.” *Iowa Public Employees’ Ret. Sys. v. MF Global*, 620 F.3d 137, 144 (2d Cir. 2010).

A two-step analysis is involved. The court must first “identify the allegedly undisclosed risk.” *Halperin*, 295 F.3d at 359. Next, “analyz[ing] the allegedly fraudulent materials in their entirety”—including the cautionary language—the court “determine[s] if a reasonable investor could have been misled into thinking that the risk that materialized and resulted in his loss did not actually exist.” *Id.* at 357, 359.

Plaintiff contends that the offering documents did not disclose that loan loss reserves might be increased, and that goodwill from the AmSouth acquisition might be reduced, because of losses in a real estate loan portfolio concentrated in the already weakening Southeast, especially Florida.

The offering materials repeatedly warned of this risk. Regions’ 2007 10-K

was filled with warnings that losses on real estate loans could worsen due to continued weakness in the housing market, increasing unemployment, and a heightened risk of a recession. The 10-K also specifically warned investors that those losses could negatively impact loan loss reserves and goodwill:

- “[T]he weakness in the homebuilder portfolio is expected to continue well into 2008. Accordingly, it is anticipated that our non-performing asset and charge-off levels will continue to increase in 2008.” JA351.
- “Management anticipates that the housing industry will remain weak throughout 2008.” JA399.
- Noting that its “residential homebuilder portfolio is geographically concentrated” in Florida and Atlanta—where “the housing slowdown has been relatively severe”—Regions stated that it “expects that losses” on “loans to real estate developers and investors,” loans for “single-family residences,” and “real estate construction loans” will “continue to rise” during 2008. JA381, 399, 400.
- “[T]he risk of recession is significantly increasing due to the negative impact housing is having on the overall economy”; “there has been a decrease in job creation and increases in unemployment in states within our footprint.” JA399.
- Because of an “increased loss rate,” Regions increased its loan loss reserves in 2007 by about 400% (to \$555 million compared to \$142 million in 2006); the hike stemmed in part from “an increase in management’s estimate of inherent losses in its residential homebuilder portfolio, as well as generally weaker conditions in the broader economy.” JA361.
- “[I]f our assumptions or judgments are wrong, our allowance for credit losses may not be sufficient to cover our actual credit losses”; “[w]e may have to increase our allowance in the future ... to adjust for changing conditions and assumptions, or as a result of any deterioration in the quality of our loan portfolio.” JA351.

- “[T]he effects of recent mortgage market challenges, combined with the ongoing decrease in residential real estate market prices and demand, could result in further price reductions in home values, adversely affecting the value of collateral securing the ... loans.” *Id.*
- “Adverse changes in the economic conditions” of the markets in which Regions operated—including Florida—“could negatively impact the financial results of Regions’ banking operations and have a negative effect on its profitability.” *Id.*
- With respect to goodwill, “[a]dverse changes in the economic environment, declining operations of the business unit, or other factors could result in a decline in implied fair value of excess purchase price,” in which case “a loss would be recognized.” JA366, 424.

Any reasonable investor reading these many warnings would have realized that Regions could suffer significant losses—which could result in increased loan loss reserves and a lower amount for goodwill—if the economy worsened and housing markets continued to decline. In *CIT Group*, 349 F. Supp. 2d at 691, the court dismissed a Section 11 claim because cautionary language in offering documents explained that the level of loan loss reserves “was the product of ‘estimates and significant judgment.’” Regions’ 10-K is similar; it noted that loan loss reserves were based on an “estimate of inherent losses” and that the allowance for credit losses may be increased if “our assumptions or judgments are wrong.” JA351, 361. See also *Hinerfeld*, 1998 WL 397852, at *6-7 (dismissing a Section 11 claim based on inadequate loss reserves because the prospectus warned that “‘general economic conditions’” could “‘worsen and lead to higher rates of

delinquency and default’”).

The risks disclosed in the 2007 10-K are precisely the risks that came to pass. “The cautionary language addresses the relevant risk directly.” *Halperin*, 295 F.3d at 360. The warnings about the housing market and the economy were “specific enough to warrant a reasonable investor’s attention.” *Olkey*, 98 F.3d at 9. To be sure, at the time no one knew just how bad things would get. But the failure to anticipate that a recession—a risk explicitly noted in the 2007 10-K (JA399)—would turn into the Great Recession is not a basis for imposing liability under the securities laws. “People in charge of an enterprise are not required to take a gloomy, fearful or defeatist view of the future.” *Rombach*, 355 F.3d at 174 (quoting *Shields*, 25 F.3d at 1129). “The Registration Statement need not predict all of the details of the contingency that came to pass”; it is sufficient if it “warn[s] of th[e] risk at a higher level of generality.” *In re Novagold Resources Sec. Litig.*, 629 F. Supp. 2d 272, 294 (S.D.N.Y. 2009).

The 2007 10-K more than adequately warns prospective investors of the risk that Regions might incur considerable losses in its real estate loans due to both weakness in the real estate market and a slumping economy; it cautions that this could adversely affect loan loss reserves and goodwill. Given that language, no reasonable investor would consider the allegedly false statements set forth in the complaint to be material. As a result, the claim against E&Y was properly

dismissed.¹⁶

CONCLUSION

The district court's judgment dismissing the complaint with prejudice against E&Y should be affirmed.

January 27, 2011

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¹⁶ In the district court, plaintiff argued that the bespeaks caution doctrine does not apply to auditors. He cited no case so holding, nor is there any reason for such a rule. Under the common law bespeaks caution doctrine, alleged misrepresentations are “immaterial” because of the offering’s cautionary language. *Rombach*, 355 F.3d at 173. The same statements cannot be material as to one defendant and immaterial as to another—materiality is viewed from the investors’ point of view, not the defendants’.

CERTIFICATE OF COMPLIANCE WITH FED. R. APP. P. 32(a)

I hereby certify that this brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B). According to the word processing program used to prepare this brief (Word 2007), this brief contains 13,869 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii), in 14-point Times New Roman typeface.

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CERTIFICATE OF SERVICE

I hereby certify that on January 27, 2011, I electronically filed the foregoing Brief of Defendant-Appellee Ernst & Young LLP with the Clerk of the Court for the United States Court of Appeals for the Second Circuit by using the CM/ECF system, which will send a Notice of Electronic Filing to all counsel of record.

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