

No. 02-6143

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

BERNARD FIDEL, et al.,
On Behalf of Themselves and All Others Similarly Situated,

Plaintiffs-Appellants,

vs.

ERNST & YOUNG, LLP,

Defendant-Appellee.

On Appeal From the United States District Court
for the Western District of Kentucky
No. 00-CV-48-M
The Honorable Joseph H. McKinley, Jr.

**DEFENDANT-APPELLEE ERNST & YOUNG LLP'S
RESPONSE TO PETITION FOR REHEARING AND
SUGGESTION OF REHEARING EN BANC**

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INTRODUCTION

Fidel offers no viable basis for panel rehearing or rehearing en banc. Panel rehearing is unwarranted because the petition simply rehashes arguments and citations from Fidel’s appeal briefs and Rule 28(j) letter that the panel unanimously found wanting. See Circuit IOP 40(a) (rehearing is “not to be used for reargument of the issues previously presented”). The petition also fails to satisfy the “rigid standards” for rehearing en banc, which is “an extraordinary procedure” requiring “a precedent-setting error of exceptional public importance or an opinion which directly conflicts with prior Supreme Court or Sixth Circuit precedent.” Circuit Rules 35(b), 35(c).

Fidel argues that the panel decision “directly conflicts” with a prior Sixth Circuit decision involving the same defendant’s audit of the same company’s financial statements, albeit for a different year. Pet. 1, citing *New England Health Care Employees Pension Fund v. Ernst & Young, LLP*, 336 F.3d 495 (6th Cir. 2003), *cert. denied*, 540 U.S. 1183 (2004). See also Pet. 2-3, 6-7. That “conflict,” however, is manufactured rather than real. In *New England*, this Court ruled on the issue of *plaintiff’s* inquiry notice, and expressly declined to reach the pleading issue decided by the panel here—whether *defendant’s* scienter had been alleged properly. See 336 F.3d at 502 (“we need not address * * * the sufficiency of the allegations of scienter”). This Court in *New England* affirmed the dismissal of a

§ 10(b) claim against Ernst & Young arising from the audit of Fruit of the Loom's 1996 financial statements because that claim was time-barred under the one-year statute of limitations then applicable to such claims. 336 F.3d at 502. Nothing in that decision conflicts with the panel's ruling here that Fidel failed to plead scienter properly, as required by the PSLRA, in challenging Ernst & Young's audit of Fruit's 1998 financial statements. Whether Fidel properly pled scienter is a very different issue from whether another plaintiff in a different case, attacking different financial statements, could and should have filed its § 10(b) claim within the limitations period.

Seeking to raise the stakes higher, Fidel argues that the panel decision also "directly conflicts" with this Court's opinion in *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671 (6th Cir. 2004), supposedly because the panel held that "a financial fraud's enormity is legally irrelevant," and can "never" demonstrate scienter, whereas *PR Diamonds* allowed that the magnitude of an accounting error may support an inference of scienter. Pet. 1, 3-4, 7. Here, again, the "conflict" is manufactured rather than real. Indeed, this purported "conflict" is based on a willful misreading of the panel's decision.

Contrary to Fidel's assertion, nowhere did the panel state that the magnitude of accounting errors can "never" be relevant to whether the complaint's allegations raise the required strong inference of scienter. Rather, the panel rejected Fidel's

argument that accounting errors of large magnitude are by themselves sufficient to show scienter (see Pl. Br. 48, Pl. Reply Br. 12-13) and found insufficient Fidel's attempt to allege fraud-by-hindsight by merely pointing to the magnitude of write-offs taken by Fruit after the period covered by Ernst & Young's audit—without alleging “any concrete facts” showing that Ernst & Young knew of or recklessly disregarded the errors when it was conducting its audit. *Fidel*, slip op. at 9. The panel expressed the concern that allowing an inference of scienter to arise simply from the magnitude of accounting errors “would eviscerate the principle that accounting errors *alone* cannot justify a finding of scienter.” *Ibid.* (emphasis added) (citing *In re Comshare Sec. Litig.*, 183 F.3d 542, 553 (6th Cir. 1999) (holding that the failure to follow accounting standards “is, *by itself*, insufficient to state a securities fraud claim”) (emphasis added)). It is clear that the panel did not rule that the magnitude of an accounting error can *never* enter into the scienter calculus, but only that magnitude *alone* does not permit an inference of scienter. That conclusion is perfectly consistent with this Court's holding in *PR Diamonds* that “when the alleged accounting errors are sufficiently *basic* and large, their existence, *in combination with other factors*, may support the requisite scienter inference.” 364 F.3d at 694 (emphasis added).

Moreover, the panel's ruling that an accounting error, regardless of its magnitude, cannot justify an inference of scienter absent specific allegations

showing that the auditor knew or recklessly disregarded facts showing the falsity of the financial statements *at the time of the audit* is not only legally correct, it is compelled by this Court's decisions in *Comshare* and *PR Diamonds*. See *Comshare*, 183 F.3d at 553 (“mere allegations that statements in one report should have been made in earlier reports do not make out a claim of securities fraud”); *PR Diamonds*, 364 F.3d at 694 (“[i]t is well-settled that violations of GAAP and GAAS, standing alone, do not create an inference of scienter, much less a strong one”; to allege scienter, the complaint must “identify specific, highly suspicious facts and circumstances *available to the auditor at the time of the audit* * * * [that] were ignored, either deliberately or recklessly”) (emphasis added). The panel's rejection of Fidel's classic fraud by hindsight claim was also compelled by the standard for alleging scienter that this Court established in *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc), requiring that a plaintiff allege specific facts that “leave little room for doubt as to misconduct.” In short, the panel's ruling is legally sound, is consistent with Sixth Circuit precedent, and raises no issue warranting rehearing.

Finally, the facts of this case show that the panel's decision was correct. As the panel noted, Fidel failed to plead facts indicating what portion, if any, of the losses that resulted in Fruit's \$220 million write-off in 1999 actually occurred during 1998, the audit year at issue. Fidel's conclusory allegation that “significant

amount[s] of the writedowns related to *activities* [not the writedowns] begun in prior years to restructure Fruit” (Cmplt. ¶ 57, emphasis added) does not even plead an error—let alone an amount—that is sufficient under *PR Diamonds*, *Comshare* or *Helwig*.

ARGUMENT

A. The Panel’s Opinion Does Not Conflict with *New England*.

In *New England*, the plaintiff initially sued Fruit of the Loom, alleging that Fruit’s audited financial statements for 1996 were fraudulent, without naming Fruit’s auditor, Ernst & Young. New England waited two years (until Fruit had filed for bankruptcy, prompting the need for an alternative “deep pocket”) to sue Ernst & Young on “the same issues” raised in its earlier complaint against Fruit. *New England*, 336 F.3d at 502. Although the exact same \$500 million basic financial statement errors were alleged in the two suits, New England argued that its two-year delay in suing Ernst & Young was compelled by its need to obtain the audit work papers, through discovery in the first suit, before it could allege a claim against the auditor. This Court disagreed, concluding that the allegations made in the first suit were “such that a reasonable investor would question the auditor’s oversight,” and that New England “should have determined” within a year to sue Ernst & Young. *Ibid*. Thus, the Court ruled that New England’s complaint against Ernst & Young was time-barred under the one-year inquiry notice rule.

New England simply held that given the allegations the plaintiff made in its suit against Fruit, the plaintiff was at least on inquiry notice of a potential claim against Ernst & Young by the time it sued Fruit, and diligent inquiry should have enabled it to establish within a year whether it had a viable claim against the auditor. *Ibid.* This Court in *New England* expressly declined to rule on the sufficiency of the allegations of scienter against Ernst & Young. *Ibid.* Nothing in that decision is inconsistent with the panel’s ruling here that the plaintiff, in a suit challenging a different audit, failed to allege scienter properly as to the auditor. There is simply no contradiction between requiring suit within one year after constructive discovery of the alleged violation and requiring that allegations of scienter be pled with particularity.

This is particularly so given the rigorous standard for alleging scienter under the PSLRA. The PSLRA requires that a securities fraud plaintiff “state with particularity facts giving rise to a *strong inference*” that the defendant acted with intent to deceive. 15 U.S.C. § 78u-4(b)(2) (emphasis added). In *Helwig*, this Court held that “the ‘strong inference’ requirement means that plaintiffs are entitled only to the most plausible of competing inferences,” those inferences that “leave little room for doubt as to misconduct.” 251 F.3d at 553. Given that exacting standard, there is no conflict—much less the “obvious and irreconcilable” conflict that Fidel professes (Pet. 6)—between this Court having concluded in *New*

England that the plaintiff failed to sue within a year of being on inquiry notice of a *potential* claim, and the panel’s conclusion here that Fidel failed to allege a *viable* claim. See, e.g., *Rothman v. Gregor*, 220 F.3d 81, 96 (2d Cir. 2000) (report was sufficient to put plaintiff on inquiry notice of potential claim against auditor but not sufficient to raise an inference of scienter against the auditor); *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 289 F. Supp. 2d 416, 424 (S.D.N.Y. 2003) (dismissing claims as time-barred under inquiry notice rule and for failure to allege scienter adequately, and rejecting as “irrelevant” “Plaintiffs’ contentions that it is unfair to require them to plead with particularity the factual basis of the fraud while at the same time dismissing the Complaints because of the existence of inquiry notice”).

B. The Panel’s Opinion Does Not Conflict with *PR Diamonds*.

Fidel argued to the panel that GAAP violations are sufficient to raise an inference of scienter so long as they give rise to “a drastic overstatement of financial results.” Pl. Reply Br. 12-13; see also Pl. Br. 48. The panel’s rejection of that argument was not only *not* inconsistent with *PR Diamonds*, it was *required* by *PR Diamonds*. See *PR Diamonds*, 364 F.3d at 694 (magnitude of accounting errors may raise inference of scienter “in combination with other factors” such as red flags that the auditor knew or must have known). The panel’s ruling was also compelled by *Comshare*. See *Comshare*, 183 F.3d at 553, 554 (“[t]he failure to

follow GAAP is, by itself, insufficient to state a securities fraud claim,” rather plaintiff must allege facts showing that the accounting errors were so “obvious” that the auditor must have known or “consciously disregarded” them). Indeed, had the panel ruled for Fidel, it would have created the very conflict between Sixth Circuit precedents that Fidel argues must be corrected.¹

The panel’s conclusion that the magnitude of an accounting correction cannot justify an inference of scienter absent specific allegations as to the defendant’s knowledge is also the view of the vast majority of courts to have considered the issue.² Indeed, the panel’s decision has already been cited with

¹ In accordance with this Court’s precedents, the panel correctly concluded that “the fact that Fruit of the Loom allegedly took over \$220 million in write-offs during 1999 in no way implies that Ernst & Young acted with scienter while auditing the 1998 financial data,” given that “[t]he class members simply have not alleged any concrete facts that would lead to a strong inference that the later inventory write-offs, even if great in magnitude, were indicative of Ernst & Young’s scienter.” *Fidel*, slip op. at 9.

² See, e.g., *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990) (“even a large column of big numbers need not add up to fraud”); *In re Suprema Specialties, Inc. Sec. Litig.*, 334 F. Supp. 2d 637, 658 (D.N.J. 2004) (rejecting plaintiff’s theory that “because the alleged fraud was so massive,” the auditor “must have known”); *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 2004 U.S. Dist. LEXIS 25894, at *161 (D. Md. Dec. 21, 2004) (“While this case does involve a massive financial restatement, this fact alone cannot establish scienter on the part of the Deloitte defendants”); *In re U.S. Aggregates, Inc. Sec. Litig.*, 235 F. Supp. 2d 1063, 1073 (N.D. Cal. 2002) (magnitude of restatement insufficient by itself to create inference of scienter, absent “additional, specific allegations that the defendants had actual knowledge of relevant facts from which scienter could be inferred”); *Geinko v. Padda*, Fed. Sec. L. Rep. (CCH) ¶ 91,624 (N.D. Ill. Sept. 28, 2001) (“The Court cannot say that the magnitude of the misstatement—especially without any context—satisfies the PSLRA’s rigorous pleading requirements.”); *Reiger v. Price Waterhouse Coopers LLP*, 117 F. Supp. 2d 1003, 1013 (S.D. Cal. 2000) (“To avoid undermining the policies of the [PSLRA] through reliance on hindsight and speculation, a court should not infer an independent accountant’s scienter based solely on the magnitude of its client’s fraud.”), *aff’d sub nom. DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385 (9th Cir. 2002); *In re Credit Acceptance Corp. Sec. Litig.*, 50 F. Supp. 2d 662, 679 (E.D. Mich. 1999) (magnitude (Continued))

approval by the Eight Circuit. See *Ferris, Baker Watts, Inc. v. Ernst & Young, LLP*, 2005 U.S. App. LEXIS 1089, at *9 (8th Cir. Jan. 21, 2005) (accounting error “does not in and of itself lead to an inference of scienter”).

The panel was also clearly correct. This Court has noted that the “especially stringent” standard for scienter on the part of an outside auditor “requires more than a misapplication of accounting principles,” but rather a mental state that “approximates an actual intent to aid in the fraud.” *PR Diamonds*, 364 F.3d at 693. As the panel recognized, the mere size of an accounting error does not show that the auditor acted with such an intent. This is particularly so where, as here, the complaint attacks the auditor’s *judgments* on technical accounting issues—not the “basic” errors discussed in *PR Diamonds*. The dollar amounts simply do not reveal the auditor’s state of mind. Thus, as the panel concluded, inferring scienter simply from the size of an alleged accounting error “invites a court to speculate as to the existence of specific (but unpled and unidentified) warning signs * * * blend[ing] hindsight, speculation and conjecture to forge a tenuous chain of inferences.” *Fidel*, slip op. at 9, quoting *Reiger*, 117 F. Supp. 2d at 1013. As this

(Continued)

of accounting error insufficient to raise inference of scienter absent allegation of specific facts showing defendants were aware of error or had deliberate ignorance); *Duncan v. Pencer*, 1996 U.S. Dist. LEXIS 401, at *35 (S.D.N.Y. Jan. 18, 1996) (inferring scienter solely from magnitude of accounting error would “obviate the scienter requirement” and “ignore the reality that scienter and falsity are distinct elements of a Section 10(b) claim” by allowing plaintiffs to establish scienter “merely by alleging that a particular statement was severely false”).

Court instructed in *Comshare*, “claims of securities fraud cannot rest on speculation and conclusory allegations.” *Comshare*, 183 F.3d at 553.³

CONCLUSION

The Petition for Rehearing and Suggestion for Rehearing En Banc should be denied.

Dated: February 21, 2005

Respectfully submitted,

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³ In a final effort to mischaracterize the panel’s decision as extreme, Fidel seizes on the panel’s observation that Fruit’s 1999 losses did not cause a restatement of its 1998 financial statements and argues that the panel’s decision conflicts with precedents in other circuits that have held that “a corporate defendant’s refusal to restate cannot bar securities fraud claims.” Pet. 9. But the panel never suggested that the absence of a restatement barred Fidel’s claims. (Indeed, in both this case and *New England*, securities fraud claims against Fruit’s insiders survived motions to dismiss in the absence of a restatement). What doomed Fidel’s claims was the failure to allege “any concrete facts” (whether a restatement or anything else) tying Fruit’s 1999 losses to any errors—let alone knowing or reckless errors—in Ernst & Young’s audit of Fruit’s 1998 financial statements. *Fidel*, slip op. at 9. Moreover, particularly where, as here, the company is in bankruptcy and there has been no restatement, the absence of a restatement means that there is no agreement (or quantification) that later writeoffs reflect errors in prior financial statements, and more rather than less must be pled to raise an inference of fraud. See *Suprema Specialties*, 334 F. Supp. 2d at 658 (absence of restatement “undermines plaintiffs’ attempt to infer knowledge based on the magnitude of the alleged fraud”). In any event, the panel noted here that the complaint would have been deficient even if there had been a restatement. See *Fidel*, slip op. at 9.

CERTIFICATE OF SERVICE

The undersigned, an attorney, hereby certifies that on February 21, 2005, he caused two copies of the foregoing *Response to Petition for Rehearing and Suggestion of Rehearing En Banc* to be served upon counsel for the Plaintiffs-Appellants, at the addresses listed below, by delivering same to the United Parcel Service for overnight delivery to:

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The undersigned further certifies that on the same date he filed one original and 25 copies of the foregoing *Response to Petition for Rehearing and Suggestion of Rehearing En Banc* with the Clerk of Court by delivering same to the United Parcel Service for overnight delivery to the Court.

Bradley J. Andreozzi