

No. 01-6523

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

NEW ENGLAND HEALTH CARE EMPLOYEES PENSION FUND,
On Behalf of Itself and All Others Similarly Situated,

Plaintiff-Appellant,

vs.

ERNST & YOUNG, LLP,

Defendant-Appellee,

On Appeal From the United States District Court
for the Western District of Kentucky
No. 1:00CV-124-M
The Honorable Joseph H. McKinley, Jr.

**FINAL BRIEF OF DEFENDANT-APPELLEE
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**DISCLOSURE OF CORPORATE AFFILIATIONS
AND FINANCIAL INTEREST**

Pursuant to 6th Cir. R. 26.1, Ernst & Young LLP makes the following disclosure:

1. Is said party a subsidiary or affiliate of a publicly owned corporation? No
2. Is there a publicly owned corporation, not a party to the appeal, that has a financial interest in the outcome? No

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July 3, 2002

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STATEMENT IN SUPPORT OF ORAL ARGUMENT

Appellee Ernst & Young LLP believes that oral argument would assist in the Court's resolution of the securities fraud and accounting issues raised in this appeal.

STATEMENT OF THE ISSUES PRESENTED FOR REVIEW

1. Whether the plaintiff shareholder's securities fraud complaint against the defendant auditor was barred by the three-year statute of repose where it was filed on June 28, 2000, the auditor's alleged misrepresentations appeared in an audit report that was prepared in February 1997 and publicly filed in March 1997, and the only alleged misrepresentation within the three-year repose period was the auditor's consent to have its report incorporated in a registration statement for newly issued securities.

2. Alternatively, whether plaintiff's complaint was untimely under the one-year statute of limitations where it was filed on June 28, 2000, the alleged securities violations all occurred in 1997, and the same plaintiff raised virtually identical allegations against the audited company in a July 1998 complaint.

3. If timely, whether plaintiff's complaint satisfies the scienter pleading requirement of the Private Securities Litigation Reform Act, where it contains no particularized allegations creating a strong inference that the defendant auditor knew of or recklessly disregarded the putative fraud by the audited company.

STATEMENT OF FACTS

Plaintiff's Complaint Against Fruit Of The Loom. In July 1998, plaintiff-appellant New England Health Care Employees Pension Fund ("New England") filed a complaint ("1998 Complaint") against Fruit of the Loom ("Fruit") and several of its officers and directors ("Fruit Insiders"). (See R.47 Exh. A Complaint, Apx. pg. 162-297). The 1998 Complaint alleged that the Fruit Insiders violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j, and the SEC's Rule 10b-5, 17 C.F.R. §240.10b-5, by falsifying Fruit's financial statements for 1996 and the first two quarters of 1997, engaging in questionable accounting procedures, and making false statements about Fruit's performance and future prospects in order to boost Fruit's stock price and thereby benefit from insider stock sales. (See R.47 Exh. A Complaint ¶¶10, 18-19, 46, 50, 117-120, 148-150, Apx. pg. 170-172, 181-189, 204-205, 208, 270-272, 285-288).

After certifying a class of all purchasers of Fruit securities between July 24, 1996 and September 5, 1997, the district court denied the defendants' motion to dismiss in August 1999, concluding that the Complaint sufficiently alleged that the Fruit Insiders had acted "knowingly, or at least, in conscious disregard of the truth and their fiduciary duty" and had engaged in "questionable accounting tactics which suspiciously qualified the board of directors for enormous bonuses." *New England*

Health Care Employees Pension Fund v. Fruit of the Loom, 1999 U.S. Dist. Lexis 12999, at *26 (W.D. Ky. Aug. 16, 1999) (Addendum to Plaintiff’s Opening Brief).

Plaintiff’s First Complaint Against E&Y. The 1998 Complaint did not name Fruit’s auditor, defendant-appellee Ernst & Young LLP (“E&Y”), as a defendant. However, after Fruit filed for Chapter 11 bankruptcy in late 1999, New England filed a complaint against E&Y in June 2000 (the “First E&Y Complaint”), purportedly on behalf of all purchasers of Fruit securities between February 12, 1997 and September 5, 1997. (R.1 Complaint, Apx. pg. 8-60). The First E&Y Complaint largely tracked the 1998 Complaint, with only minor changes to reflect the addition of E&Y. Relying on the fact that “the two cases assert substantially the same claims,” “involve the same factual and legal issues,” and contain identical allegations of accounting fraud, New England sought (unsuccessfully) to have the district court consolidate the Fruit and E&Y cases. (R.47 Memorandum of Points and Authorities, pp. 1-3, Apx. pg. 155-157).

New England’s case against E&Y rested on E&Y’s purportedly false representations, in a report prepared on February 12, 1997, that it had audited Fruit’s 1996 financial statements in accordance with generally accepted auditing standards (“GAAS”) and that those financial statements fairly represented Fruit’s financial position in conformity with generally accepted accounting principles (“GAAP”).

(R.21 Memorandum Opinion & Order, pg. 6, Apx. pg. 66). New England also alleged that E&Y's audit report representations were subsequently repeated in Fruit's March 26, 1997 Form 10-K filed with the SEC and in Fruit's April 1, 1997 Annual Report to shareholders. (*Ibid.*) In addition, New England alleged that E&Y consented to Fruit's incorporation of its audit report in Fruit's July 9, 1997 Registration Statement for a proposed sale of securities and in Fruit's August 6, 1997 amendment to that Registration Statement. (*Ibid.*)

Dismissal Of The First E&Y Complaint. E&Y filed a motion to dismiss New England's complaint, arguing that it was untimely under both the one-year statute of limitations and the three-year statute of repose set forth in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), and that it failed to allege with particularity facts giving rise to a strong inference of scienter, as required by the Private Securities Litigation Reform Act of 1995 ("PSLRA") (codified at 15 U.S.C. §78u-4 & -5). (R.5 Motion).

The district court granted E&Y's motion without prejudice. (R.21 Memorandum Opinion & Order, Apx. pg. 61). The district court first declined to accept E&Y's one-year statute of limitations argument. The court agreed with E&Y that "inquiry notice" of the alleged fraud is sufficient to trigger the statute of limitations and that "actual notice" is not necessary. (*Id.* at 12, Apx. pg. 72). But the

court ruled that it could not determine from the face of the Complaint that New England was on inquiry notice of E&Y's alleged misrepresentations more than one year prior to June 28, 2000, the date the First E&Y Complaint was filed. (*Id.* at 13-14, Apx. pg. 73-74).

However, the district court held that New England's suit was barred by the three-year statute of repose applicable to Section 10(b) claims. The court explained that E&Y's representations in its February 1997 audit report, as well as Fruit's reprinting of those representations in March and April 1997, plainly occurred more than three years before the June 2000 filing date of the First E&Y Complaint. (R.21, Memorandum Opinion & Order, pg. 15, Apx. pg. 75). The court rejected New England's contention that E&Y's consents to Fruit's reprinting of E&Y's audit report in Fruit's July 1997 Registration Statement and August 1997 amended Registration Statement (the "Consents") somehow made the earlier representations actionable or were themselves new representations triggering a new three-year repose period. (*Id.* at 18-19, Apx. pg. 78-79). The court noted that it was not holding that "there could be no set of circumstances where the reprinting or republication of a printed statement would trigger a new three year repose period," but rather that New England's complaint lacked factual allegations showing that the Consents constituted a violation of Section 10(b) and thus triggered a new repose period. (*Id.* at 18 n.16, Apx. pg. 78).

Finally, the district court held that, irrespective of its untimeliness, New England's complaint failed to state with particularity facts giving rise to a strong inference that E&Y acted with scienter, as required by the PSLRA. Instead, it found that the complaint's allegations were "based on nothing more than speculation, guesswork and hindsight" and failed to raise a strong inference that E&Y "intentionally or recklessly committed fraud." (*Id.* at 21-23, Apx. pg. 81-83).

Plaintiff's Amended Complaint Against E&Y. On March 29, 2001, New England filed an amended complaint against E&Y ("Amended Complaint"), again asserting violations of Section 10(b) and Rule 10b-5. (R.28 Amended Complaint, Apx. pg. 87-133). Other than eliminating some allegations pertaining only to the Fruit Insiders, the changes were minimal. (See R.33, Memorandum of Law in Support of E&Y's Motion to Dismiss Amended Complaint, appendix (listing changes)). The Amended Complaint now characterized E&Y's Consents to the reprinting of its audit reports as "affirmative statement[s]" that E&Y was not aware of any material deviation from GAAP in Fruit's "*unaudited*" quarterly financial statements for 1997. (R.28 Amended Complaint ¶¶47, 50, Apx. pg. 108-110). The Amended Complaint also cursorily added that, in reviewing those unaudited statements, E&Y learned of an understatement of inventory reserves and of Fruit's failure to record certain accruals. (*Id.* ¶¶96-100, Apx. pg. 127-129).

Dismissal Of The Amended E&Y Complaint. E&Y moved to dismiss the Amended Complaint, which the district court again granted based on the three-year statute of repose and New England’s failure sufficiently to allege scienter. (R.39 Memorandum Opinion & Orders, Apx. pg. 134-144). With respect to the statute of repose, the district court rejected New England’s attempt to characterize E&Y’s July and August 1997 Consents as “new and materially different” misrepresentations that triggered a new repose period. (*Id.* at 5, Apx. pg. 138). The court explained that nothing in the Amended Complaint indicated that the Consents were affirmative misrepresentations or actionable omissions as opposed to straightforward statements that E&Y “had consented to the use of its February 12 report — a report that had already been filed with the SEC — in later SEC filings.” (*Id.* at 6, Apx. pg. 139).

The district court found that New England’s additional scienter allegations did not remedy the First Complaint’s failure to satisfy the PSLRA’s scienter pleading requirement. The court explained that even if E&Y learned in 1997 about Fruit’s alleged understatements of inventory reserves and failures to record accruals, as New England alleged, such knowledge did not bear on whether E&Y misrepresented its audit of Fruit’s 1996 financial statements. At most, they could pertain only to Fruit’s *unaudited* financial reports for the first two quarters of 1997, on which E&Y had not offered an audit opinion. (R.39 Memorandum Opinion & Orders, pg. 7, Apx. pg.

140). In any event, the court continued, such allegations did not suggest anything more than “negligence” or a violation “of generally accepted accounting principles,” not the required strong inference that E&Y “committed intentional or reckless fraud.” (*Id.* at 8, Apx. pg. 141). Finally, the court explained that New England’s “motive and opportunity” allegations did not give rise to a strong inference that E&Y actually did commit securities fraud. (*Id.* at 8-9, Apx. pg. 141-142). Accordingly, the court dismissed the Amended Complaint with prejudice. (*Id.* at 10 n.4, Apx. pg. 143).^{1/}

SUMMARY OF THE ARGUMENT

New England asks for extraordinary relief. It wants this Court to be the first to hold that merely consenting to the incorporation of a prior audit report in a registration statement re-triggers the statute of repose for statements made in the earlier audit report. It wants this Court to depart from all other courts of appeals and rule that actual notice is required to trigger the statute of limitations for Section 10(b) claims and that a plaintiff may wait until it has obtained the defendant auditor’s workpapers to bring such a claim. It wants this Court to ignore the plain meaning of the PSLRA

^{1/} Beginning in March 2000, additional lawsuits were filed against the Fruit Insiders and E&Y on behalf of a purported class of purchasers of Fruit common stock between September 28, 1998 and November 4, 1999. These cases were consolidated before the district court as *Fidel v. Farley*, No. 1:00-CV-48-M. In June 2001, the district court denied the Fruit Insiders’ motion to dismiss the *Fidel* complaint but granted E&Y’s motion to dismiss based on the plaintiffs’ failure to satisfy the PSLRA’s scienter pleading requirement.

and authorize a Section 10(b) claim lacking any particularized allegations of knowing or reckless behavior on the part of the defendant auditor. The extreme deviations from established legal standards sought by New England should be rejected.

I.

This lawsuit is barred by both the statute of repose and the one-year statute of limitations applicable to Section 10(b) claims.

The district court properly ruled that the statute of repose barred New England's Section 10(b) claim. The statute of repose requires, with no exception, that Section 10(b) claims be filed within three years of the targeted misrepresentation. New England plainly filed its June 2000 complaint against E&Y more than three years after E&Y issued its February 1997 audit report, after Fruit reprinted E&Y's audit report in its March 1997 10-K, and after Fruit again reprinted it in Fruit's April 1997 Annual Report to its shareholders. For that reason, New England tries to transform E&Y's July-August 1997 Consents into actionable misrepresentations in an effort to extend the repose period. But it does not allege facts to show that E&Y knew of or recklessly disregarded any misrepresentations in the financial statements contained in the Registrations Statement in which the Consents appeared. Moreover, the Consents by their plain terms stated only that E&Y consented to the incorporation of its audit report in Fruit's Registration Statement for its new securities offerings. Thus, they

were entirely accurate and contained no misrepresentations with respect to E&Y's audit report, to Fruit's Registration Statement, to Fruit's interim 1997 quarterly financial statements (which E&Y had not audited), or to anything else.

Alternatively, this lawsuit is time-barred by the one-year statute of limitations applicable to Section 10(b) claims. New England filed its complaint against E&Y in June 2000. New England knew or should have known of its putative claim against E&Y no later than July 1998, when it filed its complaint against Fruit and the Fruit Insiders. Both complaints were based on the same allegations of accounting irregularities at Fruit and of misrepresentations in financial statements that Fruit included in the Form 10-K that it filed with the SEC in March 1997. That 10-K identified E&Y as the auditor of Fruit's financial statements, putting New England on inquiry notice as early as March 1997 that E&Y was a potential defendant in any securities fraud lawsuit involving Fruit. New England's excuse for belatedly filing this lawsuit — that it had to wait until it obtained E&Y's workpapers — is invalid as a matter of law under the established inquiry notice standard. The statute of limitations is not tolled by a lack of documentary evidence. Fruit's bankruptcy may have deprived New England of a "deep pocket" defendant, but that does not justify New England's failure to file suit against E&Y within one year of being placed on inquiry notice of E&Y's potential involvement in the events at Fruit.

II.

The Amended Complaint also fails because, as the district court properly ruled, it does not allege with particularity facts giving rise to a strong inference that E&Y acted intentionally or recklessly, as the PSLRA requires.

Most of the Amended Complaint simply recounts the Fruit Insiders' alleged misdeeds, sprinkled with conclusory assertions that E&Y "knew," E&Y "was aware of," or E&Y acted "recklessly." Since enactment of the PSLRA, the courts have consistently held that such allegations fail to satisfy the scienter pleading standard. The Amended Complaint further alleges, also in conclusory terms, E&Y's violations of GAAS and desire to earn fees, which again the courts have held are insufficient to infer the deliberate fraud or reckless indifference to fraud that a Section 10(b) claim requires. Neither New England's continual repetition of these deficient allegations nor the heated rhetoric in its brief can overcome its failure to allege particularized facts that give rise to a strong inference that E&Y committed securities fraud with the required degree of scienter.

STATEMENT OF THE APPLICABLE STANDARD OF REVIEW

New England (Br.4) misstates the standard for affirming dismissals of securities fraud claims. Since enactment of the PSLRA, it is no longer true that a dismissal may be affirmed only if the plaintiff "can prove no set of facts" to support its claim.

Instead, dismissal must be affirmed unless the complaint states “with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. §78u-4(b)(2), (3). See *Helwig v. Vencor*, 251 F.3d 540, 550, 553 (6th Cir. 2001) (en banc) (the PSLRA “strengthened the minimum showing necessary to survive a motion to dismiss,” so that “plaintiffs are entitled only to the most plausible of competing inferences”). Moreover, and irrespective of the PSLRA, a court “need not accept as true legal conclusions or unwarranted factual inferences” in the plaintiff’s complaint. *Grindstaff v. Green*, 133 F.3d 416, 421 (6th Cir. 1998).

ARGUMENT

I. THE COMPLAINT WAS PROPERLY DISMISSED AS UNTIMELY.

Securities fraud claims are subject to a one-year statute of limitations and a three-year statute of repose. “[L]itigation instituted pursuant to §10(b) and Rule 10b-5 * * * must be commenced within one year after the discovery of the facts constituting the violation and within three years after such violation.” *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991) (adopting limitations provision from 15 U.S.C. §78i(e) for use in §10(b) cases).

New England’s claim against E&Y rests entirely on alleged misrepresentations in E&Y’s February 1997 audit report that were publicly disclosed in March 1997. New England initiated this action more than three years after those events, making it

untimely under the statute of repose. Furthermore, New England knew or should have known of the alleged facts supporting its claim against E&Y at the latest when it filed virtually identical allegations against Fruit and the Fruit Insiders in July 1998. Yet, it waited another two years — until June 28, 2000 — to initiate this action, far beyond the one-year time bar. Accordingly, this action is time-barred under either the statute of repose or the statute of limitations. As demonstrated below, New England’s attempts to avoid the statute of repose and the statute of limitations are without merit.

A. The Complaint Is Barred By The Three-Year Statute Of Repose.

The Supreme Court held in *Lampf*, 501 U.S. at 364, that Section 10(b) claims must be brought within three years of the alleged misrepresentation or be forever barred. The Court emphasized that “[t]he 3-year limit is a period of repose” that is absolute and not subject to tolling. *Id.* at 363. That statute of repose bars New England’s claim, which rests on alleged misrepresentations by E&Y that it complied with GAAS in auditing Fruit’s 1996 financial statements and that those statements fairly represented Fruit’s financial position in conformity with GAAP. (R.28 Amended Complaint ¶¶32-35, Apx. pg. 99-100). E&Y made those statements in February 1997, they were publicly filed in March 1997, and they were published to all shareholders in April 1997 — over three years before New England filed the First

E&Y Complaint in May 2000. Accordingly, as the district court held, the statute of repose bars New England's claims against E&Y.

New England attempts to avoid the statute of repose by arguing that E&Y's July and August 1997 Consents were independent misrepresentations that took place within the repose period. New England appears to suggest four ways that the Consents were separately actionable under Section 10(b). None is viable, and all suffer from New England's failure to allege facts showing any Section 10(b) violation and in particular that E&Y knew of or recklessly disregarded false representations in either the Consents or the Registration Statement.

1. The Consents did not certify the accuracy of E&Y's audit report on Fruit's 1996 financial statements.

New England argues that the Consents were affirmative misrepresentations about the accuracy of E&Y's February 1997 audit report. Br.24-25. But as the district court concluded, the Amended Complaint does not allege how the Consents were misleading and thus it fails to allege the factual predicate for a Section 10(b) violation. E&Y's July 1997 consent stated:

We consent to the reference to our firm under the caption "Experts" in the Registration Statement (Form S-3) and related Prospectus of Fruit of the Loom, Inc. for the registration of Debt Securities, Preferred Stock and Class A Common Stock at an aggregate initial offering price not to exceed \$850,000,000 and to the incorporation by reference therein of our report dated February 12, 1997, with respect to the consolidated financial statements and schedule of Fruit of the Loom, Inc., included in its

Annual Report (Form 10-K) for the year ended December 1, 1996, filed with the Securities and Exchange Commission.

(R.28 Amended Complaint ¶46, Apx. pg. 108). The August 1997 consent was essentially identical. (See *id.* ¶49, Apx. pg. 109) As their plain language makes clear, the Consents made no representation, much less a false representation, about Fruit's 1996 financial statements. They unambiguously stated that Fruit had E&Y's consent to incorporate E&Y's audit report in Fruit's 1997 SEC filings for the new securities offerings. That statement was accurate, which New England does not deny. A representation that is not a misrepresentation does not violate Section 10(b). See *Santa Fe Indus. v. Green*, 430 U.S. 462, 473 (1977).

The only purpose of the Consents was to satisfy Fruit's regulatory obligation to include in its Registration Statement audited financial statements, as well as the auditor's consent to both its identification and the incorporation by reference of its opinion. See 17 C.F.R. §210.3-02(a); 15 U.S.C. §77g(a). That requirement enables investors to view previously published financial statements without having to retrieve historical documents. Because all such previously published financial statements were already publicly available, their consolidation in Fruit's Registration Statement cannot have constituted any new representation.

Significantly, New England does not cite *a single case* where such a consent has been deemed a misrepresentation in violation of Section 10(b). New England

(Br.25) relies on *McGann v. Ernst & Young*, 95 F.3d 821, superseded and amended, 102 F.3d 390 (9th Cir. 1996), but that case involved an actual “audit report contained in a Form 10-K,” not a consent to incorporate an already publicly-available audit report in a registration statement. See 102 F.3d at 397. The other two cases cited by New England (Br.26) for its consent argument, *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000), and *Frymire-Brinati v. KPMG Peat Marwick*, 2 F.3d 183 (7th Cir. 1993), are even farther afield. Neither involved an auditor’s consent or addressed whether such a consent constitutes an actionable representation. Instead, they addressed the very different issue of whether and in what circumstances a purchase or sale of securities may be “in connection with” an audit report on financial statements. See *Semerenko*, 223 F.3d at 176-177; *Frymire-Brinati*, 2 F.3d at 189-190.

With no case law support, New England argues that the district court’s rejection of its consent argument “amounts to a license to lie — tell a lie once, and you may repeat it as often as you wish without fear of again violating §10(b).” Br.26. But New England’s real beef is with the statute of repose, which obligates a plaintiff, if it thinks there was a lie, to bring its Section 10(b) claim within three years or lose it — even if the challenged statement is later repeated through incorporation by reference. See *Joseph v. Wiles*, 223 F.3d 1155, 1168 (10th Cir. 2000) (“a plaintiff must bring claims” within the repose period “or else the defendant’s liability is extinguished”). New

England's position that each reproduction of E&Y's audit report re-triggered the statute of repose would effectively abrogate the statute of repose. For that reason, the district court insisted that New England allege how each reproduction "differed in some material way" from E&Y's initial statement. (R.21 Memorandum Opinion & Order pg. 18 n.16, Apx. pg. 78). Because New England failed to do so, the district court properly dismissed its Amended Complaint.

New England also now argues that paragraph 35 of the Amended Complaint, which alleges that E&Y's February 1997 representations were "materially false and misleading," is not really the basis of its Section 10(b) claim because audit reports are directed "to a company's management and board of directors" and thus do not necessarily influence investors. Br.25. That may be, but Fruit's publicly filed March 1997 10-K and its April 1997 Report to Shareholders, both of which included E&Y's audit report, certainly did reach investors. (See R.28 Amended Complaint ¶¶36-37, Apx. pg. 102). Thus, New England's own logic required it to file suit within three years of the 10-K filing (by March 2000) or within three years of the Annual Report (by April 2000). Its failure to do so bars this lawsuit.

2. The Consents did not certify the accuracy of Fruit's Registration Statement.

New England also contends that the Consents are actionable, not because of what they said about the February 1997 audit report, but because they made Fruit's new 1997 securities offerings fraudulent. According to New England, "[a]uthorizing false offering documents" is manipulative or deceptive conduct proscribed by Section 10(b), and thus "[i]f Ernst knew its audit opinion was misleading, then consent to its use in offering documents was fraudulent." Br.24, 26. But E&Y never opined on those 1997 security offerings or on the financial state of the company in that year. Thus, its Consents cannot be actionable misrepresentations with respect to the newly registered securities. See *Danis v. USN Communications*, 121 F. Supp. 2d 1183, 1192 (N.D. Ill. 2000) (auditor's consent to include allegedly fraudulent audit report in prospectus was not a securities law violation because auditor did not "actually make misstatements or certify that misstatements are accurate").

New England argues (Br.26), relying on *McMahan & Co. v. Warehouse Entertainment*, 900 F.2d 576 (2d Cir. 1990), that literally true statements can nevertheless mislead investors. But that truism has no application here. In *McMahan*, the defendant company sold debentures that it promised could be tendered back to the company upon the occurrence of a triggering event unless the triggering event had been approved by a majority vote of the "Independent Directors." Because the

offering materials defined “Independent Directors” in a potentially misleading way, the court of appeals held that whether it was misleading was a triable issue. *Id.* at 578-579. Here, to the contrary, E&Y’s Consents said nothing misleading or potentially misleading but stated in straightforward terms that it consented to the incorporation of its previously issued audit report in Fruit’s Registration Statement. No reasonable investor could have understood those Consents to say more.

3. The Consents did not represent anything about E&Y’s review of Fruit’s interim and unaudited 1997 quarterly financial statements.

New England further argues that the Consents affirmatively misrepresented — indeed, “told the world” — that E&Y had learned nothing from its review of Fruit’s interim 1997 financial statements that required it to revise its earlier audit report or to disclose inaccuracies in the interim statements. Br.30. But as the district court found, the Amended Complaint contains no factual allegations that E&Y “did in fact discover any misrepresentations in that [audit] report requiring correction.” (R.39 Memorandum Opinion & Orders, pg. 6 n.3, Apx. pg. 139). Without such allegations, New England has no predicate for its contention that E&Y violated a purported duty to revise or disclose.

Moreover, the Consents on their face said nothing at all about Fruit’s 1997 quarterly financial statements, which the Amended Complaint expressly

acknowledges were “unaudited.” (R.28 Amended Complaint ¶96, Apx. pg. 127). New England attempts to override the plain language of the Consents by carefully alleging that the Consents “*effectively* represented that EY was not aware of any violation of GAAP in the unaudited interim financial statements” (*ibid.*, emphasis added), but the fact remains that E&Y had neither audited those statements nor expressed an opinion on them nor certified that they complied with GAAP. Indeed, the Consents contained no language that could plausibly be stretched to express E&Y’s satisfaction with the interim statements. Thus, E&Y made no affirmative representation about the interim statements that could serve as the basis for a Section 10(b) claim. See *Shapiro v. Cantor*, 123 F.3d 717, 721 (2d Cir. 1997) (“if an accountant does not issue a public opinion about a company, although it may have conducted internal audits or reviews for portions of the company, the accountant cannot subsequently be held responsible for the company’s public statements issued later merely because the accountant may know those statements are likely untrue”); *Danis*, 121 F. Supp. 2d at 1193 (rejecting §10(b) claim based on auditor’s consent where auditor “did not make any representations in the unaudited reports [but] simply reviewed them”).

Where an auditor has not expressed such an opinion, it cannot have violated Section 10(b). *Wright v. Ernst & Young*, 152 F.3d 169, 175 (2d Cir. 1998). In

Wright, the plaintiff filed a Section 10(b) claim against a company’s auditor based on the auditor’s oral approval of unaudited and allegedly false financial information contained in a press release issued by the company. The Second Circuit affirmed dismissal, rejecting the plaintiff’s argument that the market understood the press release as an implied representation by the auditor that the financial information contained in the release was accurate. As the Court of Appeals explained, because “no audit had yet been completed, there is no basis for Wright to claim that Ernst & Young had endorsed the accuracy of those results.” *Ibid*. The same is true here where no audit had been completed on the interim statements.

A recent case confirming this point is *Tricontinental Indus. v. Anixter*, 184 F. Supp. 2d 786 (N.D. Ill. 2002). As in this case, the defendant auditor consented to have its report on a company’s financial statements included in the company’s subsequent 10-K and registration statement, and the plaintiff claimed that the auditor should have disclosed alleged irregularities in two “unaudited” quarterly 10-Q reports filed by the company. *Id.* at 788. The court granted the auditor’s motion to dismiss, explaining that a defendant can be liable “only for those omissions that make his own statements misleading,” not for “the statements of others.” *Ibid*. Noting that there were no factual allegations that the auditor made any “affirmative statements about the two allegedly fraudulent quarterly reports,” the court concluded that the securities

laws do “not create a duty of an accountant to reveal its client’s improprieties.” *Ibid.* Here, too, Fruit’s interim financial statements contained only representations by Fruit, and E&Y issued no report or any other opinion on them. As in *Tricontinental*, E&Y cannot be held liable for “the statements of others.”

Even if E&Y had *implied* that Fruit’s interim statements were accurate (it did not, as explained above), an auditor’s implied representation about the statements of others is not actionable under Section 10(b). As the *Wright* court explained, holding the auditor liable in those circumstances would “effectively revive aiding and abetting liability under a different name.” 152 F.3d at 175. The court was referring to the Supreme Court’s holding in *Central Bank v. First Interstate Bank*, 511 U.S. 164, 177 (1994), that Section 10(b) does not authorize a claim against aiders and abettors to securities fraud. As in *Wright*, the courts have consistently rejected attempts to avoid the *Central Bank* holding by dressing up aiding and abetting claims against auditors in a different guise. *E.g.*, *Shapiro*, 123 F.3d at 721.^{2/}

New England nevertheless argues that E&Y had a duty to disclose any improprieties it discovered in Fruit’s interim quarterly 1997 statements. Br.30. But

^{2/} Cases cited by New England that relied on an aiding and abetting theory of liability, such as *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040 (11th Cir. 1986) (Pl. Br.28, 30), are no longer good law in light of *Central Bank*. See *Shapiro*, 123 F.3d at 720 n.2. In any event, *Rudolph* has been widely criticized for its radical expansion of auditor liability under Section 10(b). *E.g.*, *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1126 (7th Cir. 1990).

in *Latigo Ventures v. Laventhol & Horwath*, 876 F.2d 1322 (7th Cir. 1989), the court rejected a “theory of whistleblower liability,” virtually identical to that of New England here, which maintained that “accountants who participate in or even are merely aware of a fraud by a client have a duty under Rule 10b-5 [to] broadcast that fraud to anyone who might buy the client’s stock.” *Id.* at 1326; accord *Farlow v. Peat, Marwick, Mitchell*, 956 F.2d 982, 988 (10th Cir. 1992). Here, where the Complaint is devoid of factual allegations that E&Y discovered anything from its review of Fruit’s interim financial statements that called the accuracy of its audit report or Fruit’s interim statements into question, there is even less reason to impose such a duty on E&Y or to label a breach of any such duty as fraud.

New England cites auditing standards and common law tort principles as sources of a duty to disclose. But the courts have consistently rejected similar suggestions that “a failure to comply with the Auditing Standards may give rise to an action for securities fraud under section 10(b) and rule 10b-5.” *Robin*, 915 F.2d at 1126. The rationale is plain. An alleged failure to comply with those standards may constitute negligence but is not in itself fraud. See *SmarTalk Teleservices Sec. Litig.*, 124 F. Supp. 2d 505, 517 (S.D. Ohio 2000) (“An auditor’s failure to follow GAAS may demonstrate negligence, but, as the Sixth Circuit has found, violations of accounting standards standing alone do not support a strong inference of

recklessness”), citing *Comshare Sec. Litig.*, 183 F.3d 542, 553 (6th Cir. 1999). The Amended Complaint is devoid of factual allegations that would transform any such breach of duty into fraud. And the Supreme Court has made clear that it is the statutory text that determines the scope of Section 10(b) liability, not common-law tort principles. *Central Bank*, 511 U.S. at 181-182. New England has alleged securities *fraud*, not accounting malpractice.

4. New England’s “last statement made” theory is invalid.

Finally, New England argues that the period of repose did not begin to run until “the last statement made.” Br.32. The Supreme Court has rejected just such a theory in the RICO context. In *Klehr v. A.O. Smith Corp.*, 521 U.S. 179, 189 (1997), the Court rejected the Third Circuit’s view that where there is a continuing series of violations beginning prior to the limitations or repose period, the cause of action does not accrue until “the last predicate act.” New England offers no reason why that rejected theory should be revived for securities law violations. Transforming later republications of E&Y’s already public February 1997 audit report into a continuing violation of Section 10(b) would reduce the statute of repose to meaninglessness.

As the district court concluded, if each reprinting restarted the repose period, defendants would be subject to potentially indefinite and unpredictable liability, defeating the purpose of a statute of repose. See *Norris v. Wirtz*, 818 F.2d 1329, 1332

(7th Cir. 1987) (“Congress included statutes of repose [in the 1934 Act] because of fear that lingering liabilities would disrupt normal business and facilitate false claims”). Specifically, if New England’s position — that an auditor’s consent to incorporation of a prior audit report in a registration statement restarts the repose period — were accepted, the repose period for such representations could be extended to at least six years. See 17 C.F.R. §210.3-02(a). That would effectively reverse the Supreme Court’s holding in *Lampf* that the three-year repose period is absolute. See *Lampf*, 501 U.S. at 363. The district court properly declined New England’s invitation to reverse the Supreme Court.

Moreover, auditors would be loath to give their consent, or would do so only at a markedly higher price, if each such consent exposed them to continuing liability. See *Hinkle v. Henderson*, 85 F.3d 298, 302 (7th Cir. 1996) (a repose period serves “to prevent indefinite potential liability for a particular act or omission” and to afford defendants “greater certainty in predicting potential liability”). In these type of cases, a court “should attend to the practical consequences” of imposing “an extreme theory of accountants’ liability,” such as that proposed by New England. *Latigo*, 876 F.2d at 1327. It is unsurprising then that no court has imposed liability on an auditor for the type of consents targeted by New England. The district court properly rejected

New England's attempt to manufacture an unprecedented cause of action in order to justify its untimely filing.

B. The Complaint Is Barred By The One-Year Statute Of Limitations.

Although the district court ruled that this lawsuit is time-barred only by the statute of repose, it also is barred by the statute of limitations. This Court “is not restricted to ruling on the district court’s reasoning” but rather may affirm on any ground supported by the record. *Comshare*, 183 F.3d at 548. New England’s lawsuit against Fruit and the Fruit Insiders demonstrates that New England knew or should have known that it had a potential claim against E&Y by July 1998, almost two years before it filed suit against E&Y on June 28, 2000. Accordingly, this action is barred by the one-year statute of limitations.

1. The section 10(b) statute of limitations is triggered by inquiry notice.

As the district court properly ruled, the one-year statute of limitations governing Section 10(b) claims is triggered when the plaintiff is placed on “inquiry notice,” that is, when the fraud “should have” been discovered whether or not it actually was discovered. (R.21 Memorandum Opinion & Order, pg. 12, Apx. pg. 72). That ruling was consistent with this Court’s statement in *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1155 (6th Cir. 1994), that “all actions under section 10(b) and Rule 10b-5 must be brought within one year from the time the fraud was discovered or should have

been discovered.” See also *Freeman v. Laventhol & Horwath*, 34 F.3d 333, 341 (6th Cir. 1994) (in a federal securities case, “a statute of limitations begins to run when ‘the fraud is or should have been discovered’”).

New England dismisses this Court’s *Ockerman* language as “dictum” and argues in favor of an “actual notice” standard, citing only pre-*Lampf* cases from the Third Circuit. Br.41-42. However, “every circuit to have addressed the issue since *Lampf* has held that inquiry notice is the appropriate standard.” *Berry v. Valence Tech.*, 175 F.3d 699, 704 (9th Cir. 1999). The Third Circuit is part of that unanimous chorus. See *Mathews v. Kidder, Peabody*, 260 F.3d 239, 251 (3d Cir. 2001); see also *Theoharous v. Fong*, 256 F.3d 1219, 1228 (11th Cir. 2001); *Ritchey v. Horner*, 244 F.3d 635, 638-639 (8th Cir. 2001); *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1201 (10th Cir. 1998); *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 670 (7th Cir. 1998); *Dodds v. Cigna Sec.*, 12 F.3d 346, 350 (2d Cir. 1993); *Howard v. Haddad*, 962 F.2d 328, 330 (4th Cir. 1992).

New England attempts to counter this authority by relying on a footnote in *Lampf*. Br.41-43. That footnote states that “we select as the governing standard for an action under §10(b) the language of §9(e) of the 1934 Act,” which requires that a complaint be filed “within one year after the discovery of the facts constituting the violation.” *Lampf*, 501 U.S. at 364 n.9. New England contends that “discovery of the

facts” means “actual discovery.” Br.41-43. But Congress did not use the term “actual” and neither did the Supreme Court. As the Second Circuit has explained, the term “discovery” generally “includes constructive and inquiry notice as well as actual notice.” *Dodds*, 12 F.3d at 350. In light of this general rule, it is implausible that the Supreme Court intended to eliminate inquiry notice for Section 10(b) claims by way of a footnote. Furthermore, as Judge Posner has explained for the Seventh Circuit, courts always remain free to apply “the judge-made doctrine of inquiry notice” unless Congress expressly forbids it. “Nothing in the language, history, or purpose of section 9(e) forecloses so modest and traditional an exercise of judicial creativity.” *Trogenza v. Great Am. Communications*, 12 F.3d 717, 722 (7th Cir. 1993). Thus, New England’s “actual notice” argument fails, as the courts of appeals have consistently ruled post-*Lampf*.

2. The 1998 Complaint demonstrates that New England was on inquiry notice far more than one year before it filed suit.

Under the “inquiry notice” standard, “when the circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded, a duty of inquiry arises, and knowledge will be imputed to the investor who does not make such an inquiry.” *Dodds*, 12 F.3d at 350. By no later than July 1998 when it filed its complaint against Fruit and the Fruit Insiders, New England plainly was

aware, or was under a duty of inquiry to become aware, of the possibility that E&Y may have made misrepresentations.

New England alleged in the 1998 Complaint that Fruit's financial statements for 1996 and the first two quarters of 1997 were fraudulent, that those statements were "not prepared in conformity with GAAP," and that Fruit had violated proper accounting procedures. (See, *e.g.*, R.47 Exh. A Complaint ¶¶117-119, 124, 128, 135, 144-145, Apx. pg. 270-283). Those are the same allegations on which New England based its complaint against E&Y filed two years later. See *supra* p.3. As New England admits, "It is alleged in both cases that both Fruit's audited financial statements for the 1996 fiscal year, and its unaudited financial statements for the first two quarters of 1997, were materially false and misleading." Br.5. The district court was overly cautious in ruling that whether New England had a potential claim against E&Y at the time of the 1998 Complaint could not be "gleaned from the complaint itself." (R.21 Memorandum Opinion & Order, pg. 13-14, Apx. pg. 73-74). As demonstrated below, courts evaluating similar complaints have found inquiry notice established, and the statute of limitations is commonly enforced on a motion to dismiss. See *Hoover v. Langston Equip. Assocs.*, 958 F.2d 742, 744 (6th Cir. 1992) (affirming dismissal of securities fraud claim as untimely because it was "apparent from the face of the complaint that the time limit for bringing the claim has passed").

It is implausible to contend, as New England does, that it knew enough in July 1998 to claim that Fruit's financial statements were fraudulent but had no clue that it might have claims against the auditor of those very statements. Indeed, the identification of E&Y as Fruit's auditor in Fruit's March 1997 10-K, which included E&Y's audit report on Fruit's 1996 financial statements, had placed New England on notice of any E&Y involvement in the company's alleged accounting irregularities. See *Menowitz v. Brown*, 991 F.2d 36, 42 (2d Cir. 1993) (affirming dismissal of §10(b) claim where company's SEC filings, on which plaintiffs relied in the complaint they filed over one year later, put them on "inquiry notice").

The Ninth Circuit confronted a similar situation in *Stac Elec. Sec. Litig.*, 89 F.3d 1399 (9th Cir. 1996). In that case, the plaintiffs filed an amended securities fraud complaint against officers and directors of a company 16 months after filing suit against the company itself. The plaintiffs contended that they previously had lacked sufficient information to state a claim against the additional defendants. The court rejected that argument and affirmed dismissal of the claims as time-barred because all the additional defendants had been identified in the company's prospectus, thereby putting the plaintiffs on notice of their likely participation in the claimed fraud at the time they filed their original complaint. *Id.* at 1411. See also *Reisman v. KPMG Peat Marwick*, 965 F. Supp. 165, 168 n.3, 171 (D. Mass. 1997) (§10(b) claim against

auditor was untimely where it amounted to a “repackaging” of claims previously filed by other plaintiffs against the audited company and company’s 10-K filing “triggered [the plaintiffs’] duty to investigate in a reasonably diligent manner”).

An argument identical to New England’s was rejected in *Rahr v. Grant Thornton*, 142 F. Supp. 2d 793 (N.D. Tex. 2000), a case on all fours with this one. In *Rahr*, the court dismissed an investor’s securities fraud claims against an auditor based on the statute of limitations. A year before filing the claims against the auditor, the plaintiff had filed a securities fraud complaint against the president of CIC, the audited company, based on alleged accounting misrepresentations in CIC’s audited financial statements.

In response to the auditor’s motion to dismiss, the plaintiff argued, as New England does here, that his knowledge of fraud by CIC did “not equate to knowledge of fraud by its accountants.” *Rahr*, 142 F. Supp. 2d at 797. But the court explained that the proper question was “at what point [the plaintiff] acquired knowledge that would have caused a reasonable investor to investigate the possibility that the defendants had been involved in CIC’s scheme.” *Ibid*. The court concluded that “[a] reasonable investor, armed with the knowledge that CIC had been engaged in fraud and having previously relied on the specific reports and endorsements of the defendants found in the company’s public disclosures, would have continued

investigating to determine whether the defendants had also participated in CIC's fraud." *Id.* at 799. Accordingly, the plaintiff was "on inquiry notice" at the "very latest" by the time it filed its complaint against CIC's president, making its claims against the auditor "time barred." *Ibid.* That reasoning and conclusion apply to the letter here.

Again, in the recent case of *Ezra Charitable Trust v. Frontier Ins. Group*, 2002 WL 87723 (S.D.N.Y. Jan. 23, 2002), shareholders filed a Section 10(b) claim against an auditor after filing a similar claim months earlier against Frontier, the audited company. The court held that the claim against the auditor was barred by the statute of limitations because the plaintiffs were "on inquiry notice" of their claims against the auditor "at the same time" they were on inquiry notice of their claims against Frontier. *Id.* at *6. "Since plaintiffs' claims involve a single injury, plaintiffs should have brought suit against all potentially responsible parties once they were on notice." *Ibid.* Here, too, New England claims the same damages from E&Y as it earlier sought from Fruit and the Fruit Insiders, yet it failed to sue "all potentially responsible parties" within the limitations period.

New England seeks to have its dilatoriness excused on the ground that it was unable to bring its claims against E&Y until it obtained E&Y's workpapers through discovery in the Fruit case. Br.5. But the fact that the PSLRA provides for an

automatic stay of discovery pending resolution of a motion to dismiss (see 15 U.S.C. §78u-4(b)(3)(B)) shows that obtaining documentary evidence is not a prerequisite to filing a Section 10(b) claim. See *Medhekar v. United States Dist. Court*, 99 F.3d 325, 328 (9th Cir. 1996) (Congress did not intend that securities fraud actions would depend on “information produced by the defendants after the action has been filed”). Moreover, lack of evidence is not lack of notice. “Inquiry notice is triggered by evidence of the *possibility* of fraud, not full exposition of the scam itself.” *Theoharous*, 256 F.3d at 1228 (emphasis in original). Fruit’s March 1997 SEC 10-K filing was sufficient to alert New England of E&Y’s potential involvement in the alleged fraud at Fruit, and New England has no explanation for its unreasonable delay in investigating that putative involvement and in filing its claim against E&Y. See also *City Nat’l Bank v. Checkers, Simon & Rosner*, 32 F.3d 277, 283 (7th Cir. 1994) (loan default put the plaintiff lender on notice of a potential claim against auditor who prepared defaulting party’s books on which lender relied).

An analogous case is *Whitlock Corp. v. Deloitte & Touche*, 233 F.3d 1063 (7th Cir. 2000). In *Whitlock*, the buyer of a company sued Deloitte, the seller’s accountant, for failing to alert the buyer that the company’s stock had been overvalued. *Id.* at 1064. The Court of Appeals held that the suit was time-barred because the buyer had received a memorandum from its own accountant prior to the limitations period

suggesting that the seller had misled the buyer as to the value of the company's inventory. That was enough to raise a "strong suspicion, if not actual knowledge, of both injury and a wrongful cause, starting the period of limitations." *Id.* at 1065. Moreover, the limitations period began to run at that time "with respect to *all* potentially responsible persons." *Id.* at 1066 (emphasis in original). Thus, the defendant could have used the intervening period "to determine who was to blame," and it would not have had "to search hard to find Deloitte." *Ibid.* See also , 120 F.3d 893, 896 (8th Cir. 1997) (article detailing prior class action against cooperative put plaintiff on "inquiry notice" of his §10(b) claim).

In this case as well, New England did not have "to search hard" to find E&Y because E&Y was identified as Fruit's auditor in the very 10-K on which New England relied to sue Fruit. See *Havenick v. Network Express*, 981 F. Supp. 480, 521 (E.D. Mich. 1997) (dismissing complaint filed more than one year after SEC filings put plaintiffs on inquiry notice). In any event, there is no question that in July 1998 New England actually sued Fruit and the Fruit Insiders for the same alleged damages that it waited another two years to attribute to E&Y. Based on the above authority, New England knew more than enough in July 1998 to trigger the statute of limitations on New England's claims against E&Y.

The real reason New England waited so long is obvious. Fruit had filed for bankruptcy, making recovery based on the 1998 Complaint unlikely, and E&Y provided a ready “deep pocket.” The very purpose of statutes of limitations is to prevent plaintiffs from sitting on their claims in such fashion and burdening defendants with stale claims. *Young v. United States*, 122 S. Ct. 1036, 1039 (2002). Allowing a belated claim like New England’s to go forward, as the Seventh Circuit pointed out in *Trogenza*, 12 F.3d at 722, would encourage game-playing delays by potential securities fraud plaintiffs: “If the stock rebounded from the cellar they would have investment profits, and if it stayed in the cellar they would have legal damages. Heads I win, tails you lose. This tactic is discouraged by the doctrine of inquiry notice.”

For all these reasons, this Court should hold that New England’s suit against E&Y — based on the same factual allegations upon which it filed its suit against Fruit almost two years earlier — is barred by the one-year statute of limitations.

II. THE COMPLAINT WAS PROPERLY DISMISSED FOR FAILING TO PLEAD FACTS RAISING A STRONG INFERENCE OF SCIENTER.

The district court found the allegations in the initial complaint to be “conclusory” and “based on nothing more than speculation, guesswork and hindsight.” (R.21 Memorandum Opinion & Order, pg. 21, 23, Apx. pg. 81, 83). The Amended Complaint did not cure those deficiencies, raising no more than “an inference of

negligence or of violations of generally accepted accounting principles,” not the required strong inference that E&Y “committed intentional or reckless fraud.” (R.39 Memorandum Opinion & Orders, pg. 8, Apx. pg. 141). As demonstrated below, the district court accurately characterized New England’s allegations and properly dismissed the Amended Complaint with prejudice.

Scienter is a required element of a Section 10(b) claim. *Comshare Sec. Litig.*, 183 F.3d 542, 548 (6th Cir. 1999). As defined by the Supreme Court, it is a “mental state embracing intent to deceive, manipulate or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). The PSLRA requires that a securities fraud claim “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. §78u-4(b)(2). The statute expressly provides that failure to satisfy that pleading standard requires dismissal of the complaint. *Id.* §78u-4(b)(3). Thus, “claims of securities fraud cannot rest on speculation and conclusory allegations,” and mere “negligent conduct” cannot as a matter of law “give rise to liability under §10(b) or under Rule 10b-5.” *Comshare*, 183 F.3d at 550, 553. Rather, the scienter pleading requirement is satisfied only “by alleging facts giving rise to a strong inference of recklessness.” *Id.* at 549. Recklessness is conduct that is so “highly unreasonable” as to constitute “an extreme departure from the standards of ordinary care” and to create a danger that is “so

obvious that any reasonable man would have known of it.” *Id.* at 550 (citations omitted).

There are compelling policy reasons for strictly applying the PSLRA’s pleading requirement to professionals, such as auditors. As the Supreme Court has explained, “litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general.” *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975). That danger is particularly great with respect to auditors, who are often the most likely deep pocket target when a company suffers financial difficulties and whose reputations and livelihoods are acutely sensitive to accusations of fraud. For that reason, courts assessing claims against auditors under the PSLRA have required allegations of recklessness that “approximate an actual intent to aid in the fraud being perpetrated by the audited company.” *Rothman v. Gregor*, 220 F.3d 81, 98 (2d Cir. 2000).^{3/}

New England contends that it satisfied the scienter pleading standard, but the two cases from this Court on which it relies lend it no support. In *Bovee v. Coopers & Lybrand*, 272 F.3d 356 (6th Cir. 2001), the district court had failed to review the plaintiffs’ amended complaint, leading this Court to remand so that the district court

^{3/} The fact that New England had E&Y’s workpapers prior to filing this lawsuit makes its failure to allege fraud with the requisite particularity all the more inexcusable. See 15 U.S.C. §78u-4(b)(3)(B).

could conduct that review. *Id.* at 363. *Bovee* thus has no application here where the district court both reviewed the Amended Complaint and explained its deficiencies in detail. (See R.39 Memorandum Opinion & Orders, Apx. pg. 134). In the second case, *Helwig v. Vencor*, 251 F.3d 540 (6th Cir. 2001) (en banc), which did not involve claims against an auditor, this Court found that the shareholders' complaint contained abundant detail raising a strong inference of "actual knowledge" on the part of the defendant company and its managers. *Id.* at 558. As detailed below, New England's Amended Complaint is a far different animal, at least with respect to E&Y. Although sprinkled throughout with "knowledge or reckless" phraseology, it alleges conduct on the part of E&Y that at most would indicate negligence, far short of what is required by Section 10(b).

The best way to test whether New England has satisfied the scienter pleading standard is by examining what the Amended Complaint actually alleges. On a motion to dismiss, New England's case rises or falls on the allegations in its complaint, not on the rhetoric in its brief. See *Beck v. Cantor, Fitzgerald & Co.*, 621 F. Supp. 1547, 1552 (N.D. Ill. 1985). Thus, the remainder of this brief tests the allegations in the Amended Complaint against the scienter pleading standards of the PSLRA.

A. Inserting references to E&Y in allegations addressing Fruit and the Fruit Insiders does not satisfy the scienter pleading standard.

Like the 1998 Complaint against Fruit and the Fruit Insiders, the Amended Complaint against E&Y discusses at length how Fruit and the Fruit Insiders allegedly misrepresented Fruit's 1996 financial results and its prospects going forward. (*E.g.*, R.28 Amended Complaint ¶¶4-5, 27-30, 32-79, Apx. pg. 1-2, 98-120). Although E&Y is the only defendant in this action, many paragraphs of the Amended Complaint do not even mention E&Y. *Id.* ¶¶3, 6-8, 12-16, 19-21, 23-25, 28-29, 34, 38, 41-42, 44-45, 48, 51-58, 60-62, 71, 73-76, 78-79.^{4/}

The paragraphs that do mention E&Y are devoid of facts showing E&Y's involvement in or awareness of Fruit's alleged misrepresentations. Instead, the Amended Complaint is replete with highly general and conclusory allegations that E&Y's February 1997 audit report on Fruit's 1996 financials made Fruit's misrepresentations "credible" (¶5), that insider trading by the Fruit Insiders "was

^{4/} Thus, the district court's decisions to dismiss this case but not New England's case against Fruit were perfectly consistent. There is nothing unusual about a complaint sufficiently raising scienter allegations against a company and its officers but failing to do so against the company's auditor. *E.g.*, *Rothman*, 220 F.3d at 98. The 1998 Complaint alleged specific types of misconduct by the Fruit Insiders that do not bear on New England's claim against E&Y, including "numerous positive statements by the individual Defendants," "enormous amount of trading by insiders," and the directors' "enormous bonuses." See *New England Health Care*, 1999 U.S. Dist. Lexis 12999, at *26.

known” to E&Y (¶10), and that E&Y’s conduct was “knowing or reckless” (¶33). It is well settled that “conclusory allegations that the defendants ‘knowingly did this’ or ‘recklessly did that’” are insufficient to meet the pleading standard. *Lovelace v. Software Spectrum*, 78 F.3d 1015, 1019 (5th Cir. 1996).

Many of these conclusory references to E&Y are simply inserted into paragraphs of the Amended Complaint that allege facts only about Fruit and the Fruit Insiders. For example, ¶22 discusses Fruit’s installation of new management information systems (“MIS”) in 1995. The only reference to E&Y in ¶22 simply asserts that Fruit did this “with the assistance of EY” — with not a single detail of how that purported assistance took place. Similarly, ¶26 discusses Fruit’s experience with its new MIS and Vendor Managed Inventory (“VMI”) systems and simply adds “and EY” after “the officers of Fruit” with no amplification at all regarding any such experience by E&Y. See *SCB Computer Technology Sec. Litig.*, 149 F. Supp. 2d 334, 345 (W.D. Tenn. 2001) (securities fraud complaint must “allege specific claims against each defendant that satisfy Rule 9(b) and the PSLRA”).

This technique is well illustrated by paragraphs 27-29, which discuss at length Fruit’s “pull-forward” program, by which Fruit allegedly induced wholesale customers to accept shipments in 1996 for which payment would not be due until 1997. The only references to E&Y in these paragraphs state that the Fruit Insiders

benefitted “by EY’s willingness to issue an unqualified audit report on Fruit’s 1996 results,” which “EY knew * * * would come at the expense of Fruit’s 1997 results.” (R.28 Amended Complaint ¶27, Apx. pg. 98). In other words, New England simply took the fact that E&Y issued an audit report and dressed it up with words like “willingness” and “knew.” That is not the particularized pleading required by the PSLRA.

Paragraph 30 then discusses the alleged motivation of Fruit’s CEO William Farley to artificially inflate Fruit’s stock. The only reference to E&Y simply asserts that “EY knew” of Farley’s motive. Similarly, paragraphs 32 and 33 discuss a press release issued by Fruit with respect to its 1996 results. The only references to E&Y assert without any supporting detail that E&Y “consented to the issuance of this press release” and “knowingly or recklessly disregard[ed]” that the results it reported were misleading. Paragraph 40 alleges that E&Y “reviewed” another press release issued by Fruit on its first quarter 1997 results, with no details about the nature of the review, who performed it, when, where, or how it occurred, or how it was fraudulent. Not only are these allegations devoid of necessary detail about E&Y’s conduct, but the courts have consistently held that, as a matter of law, an auditor does not violate Section 10(b) based on a company press release that does not contain any statements by the auditor. *E.g., Wright*, 152 F.3d at 175. Paragraphs 35, 39, and 43 proceed to

allege that certain adverse information about Fruit’s financial performance was “known” to E&Y, again with no factual support.

B. Conclusory assertions about E&Y’s “knowledge” or “awareness” do not satisfy the scienter pleading standard.

The next section of the Amended Complaint adds no more specificity and raises no stronger inferences of scienter. Paragraphs 47 and 50 assert — with no supporting detail — that E&Y’s Consents were “an affirmative statement by EY that it was not aware of any material deviation from GAAP in the unaudited 1st Q 1997 results included in the Registration Statement.” Pursuant to the PSLRA, New England was obliged to state with particularity how those Consents made such an “affirmative statement,” especially in light of the lack of any language in the Consents saying any such thing. See, e.g., *Alfus v. Pyramid Technology Corp.*, 745 F. Supp. 1511, 1518-1519 (N.D. Cal. 1990) (there was “no affirmative statement rendered misleading by the alleged failure to disclose that the past rate of growth might not continue”). Further, New England provides no specifics to support the underlying implication, that E&Y was aware of material deviations from GAAP.

The Amended Complaint then discusses Fruit’s alleged financial misrepresentations, focusing on its purported failure to properly report and write down the value of its inventory and fixed assets, improper recognition of revenue through

its “pull-forward” program, and improper accrual recording. (See R.28 Amended Complaint ¶55, Apx. pg. 111-112).

The inventory allegations are set forth in paragraphs 58-63, which contain only one reference to E&Y. In a sentence in paragraph 59 addressing how the Fruit Insiders “caused the Company” to make recording and valuation errors, New England simply added the words “together with EY” after “Fruit’s executives.” And paragraph 63 simply asserts that “EY was aware” of factors in Fruit’s alleged misdeeds. These allegations fall far short of the particularity that the PSLRA requires to raise a strong inference of scienter, that is, knowledge or reckless disregard of a company’s fraud, not just of the details of a company’s transactions. See *O’Brien v. National Property Analysts Partners*, 936 F.2d 674, 677 (2d Cir. 1991) (affirming dismissal of securities fraud claims against auditor where plaintiffs “fail[ed] to allege particulars” regarding auditor’s purported discovery that audited company’s net worth was declining). In particular, the courts have consistently held that generalized allegations that inventory was overstated, without providing such details as the “approximate amount of the overstatement,” why the calculation was erroneous, and why the auditor should have known of the error, are insufficient. *Weinberger v. Kendrick*, 451 F. Supp. 79, 83 (S.D.N.Y. 1978).

For example, in *Ashworth Sec. Litig.*, 2000 WL 33176041, at *8 (S.D. Cal. July 18, 2000), the court dismissed allegations that inventory should have been written down because the company's inventory levels and costs were increasing while customer demand was decreasing. "The Complaint [did] not provide any specificity or examples regarding inventory levels, sales at below cost, or inventory build up," nor "allege facts indicating what contemporary information known to the defendants would have rendered the reserves false when made." The same is true here.

New England's improper revenue reporting allegations are set forth in paragraphs 64-75, which barely mention E&Y at all. Although New England argues *in its brief* (at 14) that E&Y knew that Fruit was prematurely recognizing revenue and failing to take required write-downs, that argument is no substitute for concrete allegations in the Amended Complaint. See *Thomason v. Nachtrieb*, 888 F.2d 1202, 1205 (7th Cir. 1989) ("It is a basic principle that the complaint may not be amended by the briefs in opposition to a motion to dismiss, nor can it be amended by the briefs on appeal"). Moreover, courts (including this Court) have consistently held that similar allegations fail to satisfy the scienter pleading requirement. See *Comshare*, 183 F.3d at 553 (affirming dismissal of complaint based on "revenue recognition errors"); *SCB*, 149 F. Supp. 2d at 352-353 (allegations of "improper revenue recognition procedures" did not create "a strong inference that [defendants] engaged

in behavior that represented a knowing attempt to deceive the public” or actionable recklessness); *Ashworth*, 2000 WL 33176041, at *6 (allegations that revenues were overstated failed “to identify contemporary internal reports or receipts that identify the terms of the challenged transactions”); *Sakhrani v. Brightpoint*, 2001 WL 395752, at *28 (S.D. Ind. Mar. 29, 2001) (allegation that company granted poor-credit customers favorable account terms and improperly recognized revenue from those transactions was insufficient where complaint failed to allege the magnitude of the overstatements or losses or identify the nature or recipients of the favorable terms).

For example, in an analogous case, *Greebel v. FTP Software*, 194 F.3d 185, 203 (1st Cir. 1999), the plaintiffs claimed that the defendant company “recognized revenues from sales that included a right of return, which did not meet the requirements for revenue recognition set forth in FAS 48.” The Court of Appeals held that such allegations were insufficient under the PSLRA because they lacked “such basic details as the approximate amount by which revenues and earnings were overstated; the products involved in the contingent transactions; the dates of any of the transactions; or the identities of any of the customers or [company] employees involved in the transactions.” *Id.* at 203-204 (citations omitted). The same deficiencies plague New England’s complaint, which does not identify a single transaction in which the alleged revenue recognition errors occurred, and is devoid of

any details about E&Y's purported involvement in the alleged revenue recognition scheme. See also *Holmes v. Baker*, 166 F. Supp. 2d 1362, 1379 (S.D. Fla. 2001) (dismissing §10(b) claim against an auditor because allegations that the audited company improperly recorded "buy-back" transactions as revenue did not raise a strong inference that the auditor was aware of or recklessly authorized fraudulent transactions).

New England's allegations about untimely accrual recording are set forth in paragraphs 76-77. The only references to E&Y simply assert (in ¶77) that "EY knew" of Fruit's accrual requirements, that operating performance data "was available to EY," and that Fruit's corresponding obligations "were known." These are the very type of boilerplate allegations that Congress said preclude a securities fraud claim from going forward. Moreover, a failure to detect errors in financial statements or the existence of a company's fraud is not actionable recklessness. As the Third Circuit recently put it, "the discovery of discrete errors after subjecting an audit to piercing scrutiny post-hoc does not, standing alone, support a finding of intentional deceit or of recklessness" on the part of the auditor. *IKON Office Solutions*, 277 F.3d 658, 673 (3d Cir. 2002). In other words, simply alleging that E&Y "should have" caught an error is not the stuff of fraud.

These deficiencies are not rectified by New England's assertion (Br.8) that E&Y "knew" that Fruit's financial statements were false because of E&Y's "close consulting relationship with Fruit." "[A]s a matter of law, an auditor is under no duty to disclose in an audit report deficiencies in internal controls." *SmarTalk*, 124 F. Supp. 2d at 523, citing *Adams v. Standard Knitting Mills*, 623 F.2d 422, 432 (6th Cir.1980); *Monroe v. Hughes*, 31 F.3d 772, 776 (9th Cir. 1994) (rejecting §10(b) liability for failure to disclose "findings regarding internal controls directly to the investors"). Such allegations at most "support an inference only of negligence, not recklessness." *IKON Office Solutions*, 277 F.3d at 672, citing *Danis*, 121 F. Supp. 2d at 1195. Moreover, the Amended Complaint does not allege that the auditors had any sort of relationship with the consultants or specify any linkage between anything learned from the purported consulting assignment (about which no detail is provided) and any material errors in Fruit's audited financial statements.

C. Conclusory assertions about E&Y's alleged misrepresentations do not satisfy the scienter pleading standard.

Paragraphs 80-102 of the Amended Complaint purport to detail E&Y's alleged misrepresentations in violation of Section 10(b). This is where one would expect to find particularized allegations of scienter on the part of E&Y. Instead, New England simply piles on one conclusory assertion after another. Although a tedious exercise,

review of each of these paragraphs demonstrates that they are far insufficient to satisfy the PSLRA's scienter pleading requirements.

Paragraph 80 states that E&Y "falsely represented" that Fruit's 1996 financial statements were prepared in accordance with GAAP and audited in accordance with GAAS and that E&Y "fail[ed] to require revision" of Fruit's interim 1997 quarterly statements. Again, these are just conclusory epithets, not particularized allegations of fact, and it is beyond dispute that a "failure to follow GAAP [or GAAS] is, by itself, insufficient to state a securities fraud claim." *Comshare*, 183 F.3d at 553; see also *Ziemba v. Cascade Int'l*, 256 F.3d 1194, 1208 (11th Cir. 2001); *Chill v. General Elec. Co.*, 101 F.3d 263, 270 (2d Cir. 1996); *Lovelace*, 78 F.3d at 1020; *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994). As one court recently explained, "violations of GAAP are just as consistent with the existence of an accounting problem of unknown scope as they are with intentions to hide the performance of the company." *Guess? Sec. Litig.*, 174 F. Supp. 2d 1067, 1078 (C.D. Cal. 2001).^{5/}

^{5/} New England argues that Fruit's violation of accounting standards supports a strong inference of scienter on the part of E&Y. Br.36. However, it relies on a pre-PSLRA case, *Malone v. Microdyne Corp.*, 26 F.3d 471 (4th Cir. 1994), that applied a "lenient standard of pleading to securities fraud. *Stevelman v. Alias Research*, 174 F.3d 79, 84 n.3 (2d Cir. 1999) (describing *Malone*), as well as cases that did not involve a claim against an auditor (*Baan Co.*, 103 F. Supp. 2d 1 (D.D.C. 2000)) or relied on allegations that the auditor entered into a "partnership" with the audited company to sell its products (*MicroStrategy*, 115 F. Supp. 2d 620, 654-655 (E.D. Va. 2000)), factors that do not pertain here.

Paragraph 81 alleges that EY was motivated to participate in Fruit’s purported fraud “by its desire to retain Fruit as a client [and] to generate the fees” from this and future engagements. In *Comshare*, this Court upheld a motion to dismiss based on similar allegations that the defendants “stood to receive greater compensation” from their fraudulent conduct. Those allegations showed only that the defendants “had the motive and opportunity to commit securities fraud” and did not “give rise to a strong inference that Defendants acted with recklessness.” 183 F.3d at 553. Similarly here, a desire to earn ordinary professional fees does not give rise to the required strong inference of scienter. As the Fifth Circuit explained in *Melder*, 27 F.3d at 1103, “[a] contrary conclusion would universally eliminate the state of mind requirement in securities fraud actions against accounting firms” because all accounting firms “seek to maximize their profits.” See also *SmarTalk*, 124 F. Supp. 2d at 518 (“a desire to maintain the fees flowing from a client relationship is not a sufficient basis on which to infer scienter”) (citing cases).

To be sure, motive and opportunity may in some circumstances be “catalysts to fraud and so serve as external markers to the required state of mind.” *Helwig*, 251 F.3d at 550. But as the district court found, the Amended Complaint does not provide additional factual allegations to complete the required roadmap and satisfy the PSLRA standard. (R.39 Memorandum Opinion & Orders, pg. 9, Apx. pg. 142). This is not

a case like *Frymire-Brinati*, 2 F.3d at 191, where a jury found *direct* evidence of fraud. Moreover, New England has not alleged that E&Y's fee arrangement was any different from the norm, precluding any "strong inference" of scienter. See *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1269 (10th Cir. 2001) (insiders' alleged desire to protect their positions and the value of their company stock was insufficient to infer scienter because these are "motives shared by all company executives"); *Oran v. Stafford*, 226 F.3d 275, 290 (3d Cir. 2000) (sale of stock does not indicate scienter unless "unusual in scope or timing").

The Amended Complaint continues in this vein. Paragraph 82 simply quotes from E&Y's February 1997 audit report on Fruit's 1996 financial statements. After noting that E&Y's audit report was later incorporated in Fruit's July-August Registration Statement for new securities, paragraph 83 asserts that "EY's report was false and misleading due to its failure to comply with GAAS" and to Fruit's failure to comply with GAAP. As in *Shields v. Citytrust Bancorp.*, 25 F.3d 1124, 1129 (2d Cir. 1994), the plaintiff's "pleading technique is to couple a factual statement with a conclusory allegation of fraudulent intent." That technique does not comport with the PSLRA's mandate for particularized pleading.

Paragraphs 84 and 85 discuss the meaning of GAAS without alleging any misconduct by E&Y. Paragraph 86 again charges that E&Y's 1996 audit report was

“false and misleading” for failure to comply with GAAS and GAAP, adding that E&Y’s “failure to require Fruit to revise its false interim financial reports was a violation of GAAS due to Fruit’s deviation from GAAP in the presentation of its interim 1997 results.” Paragraph 87 repeats the foregoing charges in the same conclusory fashion, alleging that E&Y’s audit report was “materially false,” that E&Y “falsely represent[ed]” compliance with GAAS and GAAP, and that E&Y “knew its reports would be relied upon” by Fruit and investors. Again, this generalized pleading suggests no more than negligence.

Paragraphs 88 and 89 allege in general terms that E&Y failed “to obtain sufficient, competent, evidential matter,” its audit was “not conducted in accordance with GAAS,” and E&Y “was aware” of factors contradicting Fruit’s results, with no facts alleged to show such awareness. The alleged factors are then presented as bullet points, in which New England periodically inserted the phrases “EY was aware,” “EY was involved,” “EY knew,” and EY “was very knowledgeable.” Buzzwords are not facts.

Paragraph 90 is even less particularized and more speculative, alleging that “EY must have know[n]” that it should have expanded its audit procedures or modified its reports. Paragraph 91 alleges that E&Y “had a duty under GAAS” to insist that Fruit revise its interim reports for the first two quarters of 1997, and paragraph 92 merely

quotes from GAAS. Paragraph 93 again alleges that E&Y “knew or should have known that Fruit was improperly reporting its results” and repeats that E&Y “failed to insist on” their revision. As this Court noted in *Bovee*, 272 F.3d at 361, a securities fraud plaintiff may not rely on “[g]eneralized and conclusory allegations” that the defendant “must have known or should have known of, and participated in, the fraud.” To the contrary, a complaint must “specifically identify the internal reports” or other nonpublic information that was known to a securities fraud defendant and made its public statements false, including “names and dates” and “who prepared [them], when they were prepared, how firm the numbers were, or which [company] officers reviewed them.” *San Leandro Emergency Med. Group v. Philip Morris*, 75 F.3d 801, 812-813 (2d Cir. 1996) (citation omitted); accord *Arazie v. Mullane*, 2 F.3d 1456, 1467 (7th Cir. 1993). Such specificity is necessary because it is “implausible to assert that because an accountant had access to a company’s internal data, it by implication was aware of any fraudulent scheme.” *Queen Uno L.P. v. Coeur d’Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1360 (D. Colo. 1998). To hold otherwise “would expose virtually any CEO, by virtue of his or her position alone, to liability.” *Comshare Sec. Litig.*, 1997 WL 1091468, at *8 (E.D. Mich. Sept. 18, 1997) (citation omitted), *aff’d*, 183 F.3d 542 (6th Cir. 1999). The Amended Complaint contains no specifics to give

flesh to its barebones allegations about information that E&Y supposedly gleaned from access to internal information at Fruit.

Paragraph 94 contains more of the same, asserting that E&Y “knew, or absent gross recklessness should have known,” that Fruit’s statements were misleading, that E&Y “falsely represented” compliance with GAAS and GAAP, and that E&Y “knew or recklessly disregarded” Fruit’s purported overstatement of 1996 income. Paragraph 95 states only that E&Y consented to have its audit report incorporated in Fruit’s July-August 1997 Registration Statement.

Paragraph 96 repeats that “EY knew” that its Consents “effectively represented” that “EY was not aware” of any GAAP violation in Fruit’s “unaudited interim financial statements.” Other than noting E&Y’s review of those interim statements, paragraph 96 contains no details concerning E&Y’s purported knowledge or awareness. Although it alleges that E&Y had “request[ed] 50 separate documents” as part of its “extensive review procedures,” no information is provided as to whether E&Y actually examined the documents, what E&Y learned from them, or what conclusions E&Y drew from its purported review. No facts are alleged to show that E&Y discovered anything in its preliminary review of the unaudited statements requiring disclosure or that its failure to make such disclosure was fraudulent. Significantly, this is not a case where an auditor withdrew or restated an erroneous

prior audit report. New England's allegations that Fruit's "forecasts" proved inaccurate and that its projected turn-around "failed" (R.28 Amended Complaint ¶49, Apx. pg. 109) say nothing about the validity of E&Y's prior audit report, must less raise an inference of fraud. The PSLRA outlawed such conclusory allegations of "fraud by hindsight." *Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1084 (9th Cir. 2002); *City of Philadelphia*, 264 F.3d at 1260. See also *Comshare*, 183 F.3d at 553 (rejecting argument that "a subsequent revelation of the falsehood of previous statements implies scienter").

Paragraph 97 alleges that, "[a]t the conclusion of its work," E&Y prepared "summary review memoranda." It does not indicate which "work" had been concluded or when the alleged memoranda were prepared. It then alleges that the "memoranda demonstrates EY's knowledge" of various allegedly improper reserve allocations on the part of Fruit. Specifically, E&Y allegedly believed that some of Fruit's inventory reserves were understated and that Fruit's legal reserve was "probably overstated," yet E&Y "did not require any revision of the financial statements." New England does not allege that E&Y believed that Fruit was engaged in fraud or that any of the reserve understatements were material. See *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (materiality is a required element of a Section 10(b) violation). As in *DiLeo v. Ernst & Young*, 901 F.2d 624, 626-628 (7th Cir.

1990), where the plaintiffs alleged that the auditor should have realized that the audited company had “not increase[d] its reserves fast enough,” New England has not alleged facts that would show that E&Y was “so much as negligent” — much less reckless — in conducting its audit.

Paragraph 98 states that, after reviewing Fruit’s interim financial statements for the first quarter of 1997, E&Y prepared a Summary of Audit Differences (“SAD”) that allegedly contained several items “in which EY disagreed with Fruit’s judgment.” Paragraph 99 claims that these items on the SAD showed E&Y’s “knowledge of significant problems in Fruit’s accounting.” The only support for that proposition is an allegation that “a lower level EY auditor” noted his belief that Fruit’s inventory loss reserve was understated by \$1.8 million and his intention to post the difference to the SAD, and that “a more senior EY accountant” decided not to post the difference. Paragraph 99 then acknowledges that the SAD explains why “no adjustment was necessary,” namely, that Fruit “had made an error booking an inventory variance.” The Amended Complaint nowhere alleges that Fruit had not made such an error, that the senior accountant’s judgment was wrong (much less fraud-driven), or that any such adjustment was material. See *IKON*, 277 F.3d at 676 (no showing that \$6.2 million misrepresentation on Summary of Audit Differences that allegedly was “known” to auditor was “material”). Instead, New England simply

assumes (and expects the Court to assume) that a supervisor's revision of a discretionary accounting decision represents something shady. But such revisions are part and parcel of the auditing process, in which judgment and discretion gained through experience play a significant part. "[A]n ethical, reasonably diligent accountant may choose to apply any of a variety of acceptable accounting procedures when that accountant prepares a financial statement." *Lovelace*, 78 F.3d at 1021.

Paragraph 100 alleges that EY was "in position to learn about Fruit's improper accounting as of March 31, 1997" and "***actually did know***" about many of the problems, that E&Y's Consents and failure to revise its audit report were an "affirmative statement" that E&Y was "unaware" of GAAP violations, that E&Y "knew" that Fruit had failed to record necessary accruals, and that E&Y's consent was "false and misleading and in violation of GAAS." (Emphasis in original.) Using bold italic font and adding the modifier "actually" do nothing to rehabilitate conclusory allegations.

Paragraph 101 alleges that it is "likely" that E&Y, Fruit, or Fruit's customers possess documents that will evidence E&Y's "knowledge of its false statements and of [its] motivation," as well as E&Y's "intimate knowledge of Fruit and its practices." The alleged documents are not specified other than to indicate that they concern the 1997 fiscal year. Speculation about the existence of such documents and placement

of the adjective “intimate” before knowledge do not substitute for the particularized allegations required by the PSLRA.

Finally, paragraph 102 ends this litany of bald assertions by simply listing the GAAS standards that E&Y allegedly violated, without indicating how E&Y did so in this case.

D. The arguments in New England’s brief cannot overcome the deficiencies in the Amended Complaint.

The exegesis above demonstrates that the district court got it right and that the Amended Complaint fails to comply with the federal standard for pleading scienter in securities fraud cases. Notwithstanding its failure to set forth particularized allegations raising a strong inference of scienter, New England now argues that the “*size*” of Fruit’s alleged violations supports its claim of recklessness on the part of E&Y. Br.36 (emphasis in original). But “even a large column of big numbers need not add up to fraud” (*DiLeo*, 901 F.2d at 627), and the “sheer magnitude” of a company’s accounting errors does not support a strong inference of scienter on the part of its auditor. *Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 155 (D. Mass. 2001). See also *Comshare*, 183 F.3d at 553 (allegation that GAAP violations “occurred over a long period of time” did not satisfy the scienter pleading requirement).

New England also seeks to overcome the deficiencies of the Amended Complaint with snippets from speeches and news articles that address current

concerns about problems in the accounting industry. Br.38-39. But that is just a diversion. Because the Amended Complaint does not “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind” (15 U.S.C. §78u-4(b)(2)), it was properly dismissed.

* * * * *

After permitting New England to amend its initial complaint, the district court dismissed the Amended Complaint with prejudice. “A court is within its discretion to refuse amendment and dismiss the complaint if it concludes that the pleading as amended could not withstand a motion to dismiss” and thus would be “futile.” *Hoover*, 958 F.2d at 745-746; *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1041 (6th Cir. 1991). Moreover, as Judge Feikens has explained, the PSLRA’s “high standard of pleading” would be “meaningless if judges on a case-by-case basis grant leave to amend numerous times.” *Champion Enters. Sec. Litig.*, 145 F. Supp. 2d 871, 873 (E.D. Mich. 2001).

Amendment here would be futile. New England has already had two chances to allege a timely complaint and, even with the E&Y workpapers in its possession, has proven unable to comply with the PSLRA pleading standards. New England offers no valid reason to provide it with yet a third bite at the apple. Although it asserts that the “legal standards” are “developing” (Br.44), *Lampf* established the one-year statute

of limitations and three-year statute of repose in 1991, and the PSLRA established the scienter pleading standard in 1995. The futility of still another amended complaint is confirmed by New England's failure even to suggest what it would allege differently. See *Blakely v. United States*, 276 F.3d 853, 874-876 (6th Cir. 2002) (upholding denial of second amended fraud complaint where further amendment "would be futile").

CONCLUSION

The judgment of the district court should be affirmed.

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Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

The undersigned hereby certifies that the Final Brief of Appellee Ernst & Young LLP contains 13,991 words and complies with the type-volume limitation in Federal Rule of Appellate Procedure 32(a)(7)(B).

One of Ernst & Young LLP's attorneys

**DEFENDANT-APPELLEE'S DESIGNATION
OF APPENDIX CONTENTS**

<u>Document</u>	<u>Record Number</u>
Plaintiff's Motion to Consolidate, including Exhibit A	R.47
Plaintiff's June 28, 2000 Complaint against E&Y	R.1

CERTIFICATE OF SERVICE

The undersigned, an attorney, hereby certifies that on July 3, 2002 he caused one copy of the foregoing Final Brief of Defendant-Appellee Ernst & Young LLP to be served upon each of the following by U.S. Postal Service, first class mail:

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