NO. 01-1553

In the United States Court of Appeals
for the Third Circuit

**IN RE: IKON OFFICE SOLUTIONS, INC.
SECURITIES LITIGATION**

Appeal from the United States District Court
for the Eastern District of Pennsylvania

BRIEF OF DEFENDANT-APPELLEE ERNST & YOUNG LLP

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RELATED CASES AND PROCEEDINGS

There are no related proceedings currently pending before this Court. An appeal of the district court's approval of a settlement in this case between appellants and all defendants other than Ernst & Young was voluntarily dismissed. *Chapman, et al.* v. *IKON Office Solutions, Inc.*, No. 00-1913. Currently pending before the trial court is *Whetman* v. *IKON Office Solutions, Inc.,* Civ. Action No. 00-87, MDL No. 1318, which was consolidated with this case for pre-trial proceedings only. Ernst & Young is not a party to that action.

STATEMENT OF JURISDICTION

Appellants' statement of jurisdiction is complete and accurate.

STATEMENT OF THE ISSUES

Appellants' statement of the issues is complete and accurate.

INTRODUCTION AND SUMMARY OF ARGUMENT

Defendant-appellee Ernst & Young LLP ("E&Y") respectfully asks this Court to affirm the judgment of the United States District Court for the Eastern District of Pennsylvania (Katz, S.J.) granting summary judgment in appellee's favor. In a meticulous 27-page Memorandum Opinion, Judge Katz faithfully applied well-settled legal principles and concluded that E&Y was entitled to summary judgment on independently sufficient grounds. *In re IKON Office Solutions, Inc. Sec. Litig.*, 131 F. Supp. 2d 680 (E.D. Pa. 2001).

First, the court held that appellants had not adduced sufficient proof of loss causation. Applying the legal test articulated by the Eleventh Circuit in *Robbins* v. *Koger Properties, Inc.*, 116 F.3d 1441 (11th Cir. 1997) – and adopted by this Court in *Semerenko* v. *Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000) – Judge Katz held that, even if the price of IKON stock had been "artificially inflated" by the alleged fraud, there was *no* evidence (much less legally sufficient evidence) "'that the artificial inflation was actually "lost" due to the alleged fraud.'" 131 F. Supp. 2d at 687 (quoting *Semerenko*, 223 F.3d at 185). "[T]he determinative factor," Judge Katz stated, "is that there is no evidence that the alleged misstatements caused the loss, as opposed to or in addition to other factors." *Id*. at 690. On that ground alone, the court held, summary judgment was warranted.

But the district court did not stop there. It also ruled against appellants on the element of scienter. Applying the standard articulated in *McLean* v. *Alexander*, 599 F.2d 1190 (3d Cir. 1979), Judge Katz held (131 F. Supp. 2d at 692) that appellants failed to amass the very substantial quantum of proof required to show either a "knowing" misrepresentation (requiring actual knowledge of a false statement) or a "reckless" misrepresentation (requiring "shoddy accounting practices amounting at best to a pretended audit"). Judge Katz carefully analyzed appellants' allegations, measured them against the governing legal standards, and appropriately found them wanting. On this ground as well, the court entered summary judgment in E&Y's favor.

Finally, and in the alternative, the district court granted partial summary judgment with respect to those class members who had purchased IKON securities after IKON's October 15, 1997 press release announcing its fourth-quarter and year-end earnings, but *before* the public release of E&Y's audit opinion on IKON's year-end financial statements on December 24, 1997. Judge Katz noted that IKON's press release, although reviewed by E&Y before it went out, was not attributed to E&Y in any way. Applying the Supreme Court's decision in *Central Bank of Denver* v. *First Interstate Bank of Denver*, 511 U.S. 164 (1994) – which rejected aiding-and-abetting liability under Section 10(b) – Judge Katz held that E&Y could not be held liable for the press release issued by IKON on October 15.

In short, Judge Katz did precisely what the Supreme Court's summary judgment decisions command: He sifted (not weighed) the evidence; he measured that evidence against uncontroverted legal standards; and in the end, he held that appellants were unable to establish the existence "of an element" – actually *two* elements – "essential to [their] case, and on which [they would] bear the burden of proof at trial." *Celotex Corp.* v. *Catrett*, 477 U.S. 317, 322 (1986).

But you'd never know that to read appellants' brief. Remarkably, in a document nearly 100 pages long, appellants devote not a single paragraph to what the trial court actually said. True, there are snippets here and there lifted from the district court's opinion – but nothing that conveys the care and comprehensiveness with which Judge Katz analyzed the voluminous summary judgment record, grappled with appellants' litany of allegations, and concluded that appellants' case simply does not meet the governing legal standards.

Indeed, although they present fully 65 pages of factual (or fact-like) material, appellants do not ever identify the governing legal standards. And small wonder – because under the legal standards that control this case, summary judgment was plainly warranted. The decision of the district court should therefore be affirmed.

STATEMENT OF FACTS

A. Background

1. IKON supplies copiers, printing systems, and related services throughout the United States, Canada, and Europe. 131 F. Supp. 2d at 684. Its shares are traded on the New York Stock Exchange. *Ibid*. Between 1995 and 1998, IKON grew rapidly through the acquisition of nearly 200 smaller companies. Pursuant to an

ambitious "transformation program," the company attempted to integrate its various offices and newly acquired companies into a single, cohesive network. *Ibid*.[1]

E&Y, one of the "Big Five" accounting firms, served as the independent, outside auditor of IKON's September 30 fiscal year-end financial statements for many years. J.A. 113-14 (2d Am. Cplt. ¶ 101). The purpose of the year-end audit was to provide an opinion whether IKON's consolidated year-end financial statements presented fairly, in all material respects, the financial position of the company in accordance with Generally Accepted Accounting Principles ("GAAP").[2] GAAP "is a technical accounting term that encompasses the conventions, rules and procedures necessary to define accepted accounting practices at a particular time." AICPA Professional Standards, AU § 411.02; see 131 F. Supp. 2d at 685 n.4. GAAP is

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[1] The "transformed" IKON was ultimately to comprise (i) thirteen "business services" districts, each engaged in selling and leasing photocopiers and other office equipment, (ii) IKON Capital (IKON's leasing arm), (iii) IKON Document Services ("IDS") (providing large-scale photocopying facilities), (iv) IKON Management Services ("IMS") (providing office management services on an outsourced basis) and (v) IKON Technology Services (encompassing a range of technology companies).

[2] Beginning in 1997, IKON "outsourced" certain of its internal auditing functions to E&Y. 131 F. Supp. 2d at 684. Thus, during IKON's fiscal year ending on September 30, 1997, E&Y personnel visited various IKON business units and performed internal audit work. Unlike the year-end audit of the financial statements, the purpose of the internal audit work was "to determine whether those units were in compliance with IKON's polices and procedures." J.A. 115 (2d Am. Cplt. ¶ 105).

designed to provide a common framework for making judgments that result in reasonably comparable financial statements from year to year across a spectrum of companies. J.A. 4702-03 (Graham Rpt.).

Because of IKON's large size (more than $5 billion in both assets and revenues) and decentralized structure (more than 100 operating entities), the 1997 year-end audit of IKON's consolidated financial statements involved an enormous amount of work. Even the planning of the audit took months and involved the input of numerous E&Y and IKON personnel. During the planning process, E&Y's engagement team evaluated IKON's internal controls, reviewed the results of prior year-end audits and of IKON's fiscal year 1997 internal audits, and took careful account of the nature of IKON's business as well as the effects of its transformation and acquisition programs. J.A. 5446-48 (Mulherin Decl. ¶¶ 6-11).

The audit itself was performed according to Generally Accepted Auditing Standards ("GAAS"). As such, it was designed to provide "reasonable assurance" as to whether the consolidated financial statements, taken as a whole, were free of material misstatement. AU §§ 508.07, 230.13. As the professional standards make clear, an auditor is not an insurer, and the audit opinion does not guarantee the accuracy of the financial statements; rather, the audit provides only reasonable, not absolute, assurance that the financial statements are free of material misstatements.

Id. § 230.13. Nor does an audit involve an examination of 100% of a company's accounting records, which would be time- and cost-prohibitive. *Id*. §§ 326.22, 326.23. Instead, auditors examine, "on a test basis," selected underlying data sufficient to provide "a reasonable basis" for the audit opinion. *Id*. § 508.08. Finally, the professional standards recognize that financial statements are the result of estimates and approximations, and that an auditor must necessarily exercise professional judgment in designing and performing the audit. *Id*. § 230.11. See J.A. 5091 (Devor Dep. 305-06).

Applying these principles, E&Y determined that it would perform "specific scope" audits (testing of material account balances and transactions) at eight locations that accounted for $1.97 billion of IKON's revenues, and full scope audits at additional locations such as IKON Capital. J.A. 5448 (Mulherin Decl. ¶ 12-13). In the months that followed, seasoned E&Y personnel from across the country performed the audit procedures. *Id*. at 5449 (¶ 14). As new issues and challenges arose, E&Y expanded its procedures accordingly. E&Y ultimately exceeded its budget for the 1997 year-end audit by more than 20%, devoting more than 10,000 hours to the engagement (compared with a budget of 8,250 hours). *Id*. at 5450 (¶ 19).

E&Y's unqualified or "clean" audit opinion on IKON's 1997 financial statements was publicly released on December 24, 1997.[3] The audit opinion, which follows conventional form under GAAS, stated that E&Y had conducted its audit "in accordance with" GAAS and that, "in our opinion," the consolidated financial statements of IKON, as prepared by IKON management, "present fairly, in all material respects, the consolidated financial position of [IKON] . . . in conformity with [GAAP]." See 131 F. Supp. 2d at 684 n.3, 684.[4]

2. Over the course of fiscal 1998, IKON began to experience a range of operational difficulties. On April 22, 1998, the company announced that its second quarter earnings would be lower than expected and warned that its third and fourth quarter earnings would also fall below expectations. 131 F. Supp. 2d at 684; J.A. 1624-25 (PR Newswire). IKON attributed the shortfall to "three major factors – (1) issues related to our ongoing transformation process; (2) competitive pricing pressures which have reduced margins on the equipment side of the business; and (3) product rationalization – focusing on the products that provide the best solutions for

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[3] The opinion was dated as of October 15, 1997, except for note 8, which was dated October 27, 1997. J.A. 4701 (Graham Rpt.).

[4] On October 15, 1997, IKON had issued a press release announcing the results of its operations for the fiscal year ended September 30, 1997. 131 F. Supp. 2d at 684, 685 n.5. The press release was reviewed by E&Y personnel before it was issued, but it did not mention E&Y, nor did it refer to an audit. *Ibid*.

our customers." J.A. 1624. The company's stock price fell significantly that day, and continued to fall through the spring and summer of 1998 in the wake of substantially identical announcements. 131 F. Supp. 2d at 684.

In late June, shortly after its discovery of transformation-related problems in the Florida District (J.A. 4710-11 (Graham Rpt.)), IKON engaged E&Y to participate in an exhaustive review of the books of each of IKON's North American and U.K. business services units, a project that was known as the "Special Procedures." 11/9/2000 Joint Stipulation of Uncontested Facts. The purpose of the Special Procedures was to determine whether unidentified transformation-related problems existed at other IKON locations. J.A. 3531-32 (Dillon Dep. 77-80). To assist in this process, the IKON Board of Directors engaged Arthur Andersen, a major accounting firm, to serve as an independent check on E&Y's work. Andersen began by thoroughly reviewing E&Y's workpapers from the 1997 audit and had full access to E&Y's documents and personnel involved in the Special Procedures. Andersen partners devoted hundreds of hours to performing this review. J.A. 3184-85, 3233.

On August 14, 1998, at the conclusion of the Special Procedures, IKON announced a $110 million charge to earnings – $94 million in pre-tax charges applied to its 1998 third quarter earnings, and a restatement of its previously reported, unaudited second quarter earnings to reflect $16 million in pre-tax charges. J.A. 2459.

The charges consisted of increases in the reserves for lease defaults and accounts receivable, adjustments related to the breakdown in internal controls at certain operating units, and other adjustments. IKON management concluded, however, that it did not need to restate the company's 1997 year-end consolidated financial statements. Arthur Andersen, which was serving as a "second pair of eyes" for the IKON Board (J.A. 3336 (Forese Dep. 59)), concurred in that judgment: It attended the board meeting at which IKON and E&Y discussed the proposed charges; it reviewed the charges and the basis for their allocation to the 1998 quarters; and it concurred both in the allocation decision and in the decision not to restate the 1997 financial statements. J.A. 3188, 3191-92 (McAleer Dep.); J.A. 3195, 3259-60 (Costello Dep.).

In contrast to the earlier press releases, which revealed the company's unexpectedly poor business performance, the August 14, 1998 release announced that the $110 million in charges related to *accounting* issues. As such, the charges were treated by market analysts "as a one-time, non-recurring event with no permanent implications for IKON's ability to generate after-tax cash flows in the future." J.A. 2359 (Ruback Rpt.). The price of the stock did not fall in response to this announcement of accounting charges. 131 F. Supp. 2d at 687; J.A. 1344, 1491 (Jarrell Rpt.).

B. Procedural History

1. Shortly after the charges were announced, appellants filed this suit against IKON and certain individual defendants, asserting violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t(a), and of Rule 10b-5, 17 C.F.R. § 240.10b-5. Just weeks before the close of discovery, appellants filed an amended complaint, adding E&Y as a defendant on the claim under Section 10(b) and Rule 10b-5. Appellants later moved to certify a class of all those who acquired IKON securities between October 15, 1997 (the day of IKON's press release concerning its 1997 year-end results) and August 13, 1998 (the day before IKON announced the $110 million in charges against earnings), alleging that E&Y's audit opinion on IKON's 1997 year-end financial statements was false in that the 1997 financial statements substantially overstated IKON's income.

On July 19, 1999, E&Y moved to dismiss the 10b-5 claim, contending in part that appellants had failed to plead scienter with the particularity required by Fed. R. Civ. P. 9(b) and the Private Securities Litigation Reform Act. The district court denied the motion, pointing to the "great detail" contained in certain of appellants' allegations. *In re IKON Office Solutions, Inc. Sec. Litig.*, 66 F. Supp. 2d 622 (E.D. Pa. 1999). As discovery later revealed, however, these critical allegations were without any factual basis. For example, appellants no longer claim that E&Y improperly allowed IKON's lease default reserve to be understated by $32 million in

1997 (see J.A. 130-31 (2d Am. Cplt. ¶¶ 133-35)), or that E&Y improperly permitted IKON to wait until 1998 to write off Integra, a technology company purchased by IKON in 1996. *Id*. at 133-35 (¶¶ 138-44). Nor do plaintiffs any longer assert claims about improper revenue recognition under IKON's Copy Management Program. *Id*. at 77-80 (¶¶ 29-34).

Appellants have also backpedaled from their inflammatory allegation (cited by the district court in denying E&Y's motion to dismiss, 66 F. Supp. 2d at 629) that E&Y consented to have its audit opinion on IKON's 1996 financial statements incorporated into IKON's "May 1997 Registration Statement," even though E&Y had been advised that IKON's CFO, Kurt Dinkelacker, was "cooking the books."[5] "According to plaintiffs," the court noted in its opinion on the motion to dismiss, "E&Y thus placed its imprimatur on Dinkelacker's supposed efforts to misstate financial accounts." 66 F. Supp. 2d at 629. Discovery, however, soon gave the lie to that allegation (see *infra* at ___), and in due course appellants stipulated to dismiss the Section 11 claim that had been grounded on this "cooking the books" theory. J.A. 52.

2. On February 6, 2001, following lengthy briefing and extensive oral argument, the district court entered summary judgment in E&Y's favor on

[5] That claim, brought under Section 11 of the Securities Act, 15 U.S.C. § 77k, was first raised against E&Y in appellants' Second Amended Complaint, J.A. 152-54 (¶¶ 178, 182-83).

independent grounds.[6] The court first held that appellants had failed to adduce sufficient evidence of loss causation. To prove that element, the court explained, a plaintiff must show that (1) he or she "purchased a security at market price that was artificially inflated due to a fraudulent misrepresentation"; and (2) "the artificial inflation was 'lost' due to the alleged fraud." 131 F. Supp. 2d at 687 (quoting *Semerenko*, 223 F.3d at 184). In this case, the court determined, appellants failed to meet the second part of the test, adducing *no* evidence (much less *sufficient* evidence) that the price of IKON stock had "dropped in response to disclosure of the alleged misrepresentations." *Ibid*. (quoting *Semerenko*, 223 F.3d at 186).

The court scrupulously analyzed each purported "disclosure" of the "fraud" to see whether it was accompanied by a drop in the price of IKON stock. It looked first at the announcement of the $110 million in charges on August 14, 1998; but on that day the price of IKON stock did not decline. 131 F. Supp. 2d at 687. The court next addressed appellants' theory that the relevant disclosures had been made *before* August 14 – in the form of "leaks." J.A. 2523-24 (Jarrell Dep. 223-24). Here again, however, the court found that "[p]laintiffs ha[d] not met th[eir] burden . . . to provide evidence supporting a reasonable inference that such disclosures were in fact made,

[6] On May 9, 2000, the district court had approved a settlement of all claims against IKON and the individual defendants, leaving E&Y as the sole remaining defendant.

and that they were a proximate cause of loss." 131 F. Supp. 2d at 687. To the contrary, the court stated, nothing in the record suggested "that the stock decline was caused by anything other than business conditions and operational and management problems." *Ibid*. The court therefore entered summary judgment for want of loss causation. *Id*. at 691.

The court also granted summary judgment on the independent ground that appellants had adduced insufficient evidence of scienter. To hold an auditor liable under Section 10(b), the court explained, a plaintiff must show either that the auditor knowingly made a false statement, or that it acted "recklessly" – a standard that covers only the extraordinary case "where the reckless acts constitute 'highly unreasonable conduct, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'" 131 F. Supp. 2d at 691 (quoting *McLean*, 599 F.2d at 1197). The court observed that in this Circuit, as elsewhere, recklessness "is 'relatively close to intentional conduct.'" *Id*. at 692 (quoting *Healey* v. *Catalyst Recovery of Penn.*, 616 F.2d 641, 649 (3d Cir. 1980)).

The court thoroughly canvassed all of appellants' proffered grounds for inferring scienter and held them insufficient. Judge Katz first rejected the contention that, during the course of the 1997 audit, E&Y encountered, but did not appropriately address, certain "'red flags' that should have alerted Ernst that IKON might be concocting fraudulent numbers." *Id*. at 693. The court concluded that "[t]he evidence in this case indicates that Ernst did not fail to respond to the red flags it encountered, but that it received reasonable assurances that the top management at IKON was informed of all potential problems and that all allegations received due investigation by outside counsel." *Id*. at 694-695. "Under these circumstances," the court held, "Ernst's responses to the allegations of fraud do not reasonably permit an inference that Ernst engaged in 'highly unreasonable conduct, involving . . . an extreme departure from the standards of ordinary care.'" *Id*. at 697 (quoting *McLean*, 599 F.2d at 1197).

The court next addressed appellants' contention that E&Y knew that IKON's internal accounting system was unreliable, and thus acted recklessly by providing a clean audit opinion on IKON's 1997 financial statements. Examining the various allegations, the court concluded: "Far from supporting plaintiffs' claim that Ernst must have acted recklessly simply because it knew that IKON's internal controls were deficient . . . the evidence here indicates that Ernst used that knowledge to try to ferret out and improve the faulty controls, and made obvious attempts to avoid undue reliance on them." *Id*. at 698.

The court also rejected appellants' suggestion that the Special Procedures in 1998 amounted to a "cover-up." *Ibid*. Judge Katz observed that there was no evidence "as to how the allegedly blatant cover-up escaped the notice of the investigators, or evidence suggesting that Andersen was somehow involved in the cover-up." *Id*. at 699. The court also noted that Arthur Andersen had "concurred with the decision not to restate the FY97 financial statements." *Ibid*.

Finally, the court turned to appellants' discrete claims of 1997 accounting and auditing errors at various IKON business units. The court explained that a "failure to follow professional standards by itself does not necessarily establish scienter, nor does the use of unreasonable accounting procedures." *Id*. at 703. And of course, "discrete examples of deficient accounting procedures" must be considered "in light of the evidence reflecting the scope of work actually performed by Ernst." *Ibid*. In this case, the court noted, the sheer volume and detail of E&Y's audit work "make it difficult to raise an inference of scienter, especially in light of the highly detailed documentary evidence of Ernst's procedures, calculations and findings, which Ernst itself produced in the course of its audit." *Id*. at 704. The court then examined each of the "discrete calculations" that appellants presented and concluded that none of them, alone or together, sufficed to raise an inference of scienter. *Id*. at 694.

Having granted complete summary judgment on two different grounds, the court then granted partial summary judgment, in the alternative, as to the claims of all plaintiffs who purchased IKON securities before December 24, 1997, holding that IKON's October 15, 1997 press release could not form the basis for a Rule 10b-5 claim against E&Y. *Id*. at 685 n.5. The court explained that Rule 10b-5 prohibits only "the *making* of a material misstatement (or omission)," and does not extend merely to "giving aid to a person who commits a manipulative or deceptive act." *Ibid*. (quoting *Central Bank of Denver* v. *First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994) (emphasis added)). Because E&Y auditors had only reviewed IKON's press release – but neither was the firm mentioned in the release nor were IKON's numbers said to be "audited" – the court held that E&Y's involvement did "not amount to actually *making* a false misrepresentation." *Ibid*. (emphasis added).

STATEMENT OF THE STANDARD OF REVIEW

This Court's review of a district court's grant of summary judgment is plenary, and is governed by the same standards that apply to the district court in considering the summary judgment motion. *Kline* v. *First Western Gov't Sec., Inc.*, 24 F.3d 480, 485 (3d Cir. 1994). Under those standards, summary judgment is warranted when the submissions in the record "show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ.

P. 56(c). "A motion for summary judgment must be granted unless the party opposing the motion can produce evidence which, when considered in light of that party's burden of proof at trial, could be a basis for a jury finding in that party's favor." *Kline*, 24 F.3d at 485.

True enough, courts must not "weigh the evidence or determine the truth of the matter" (Br. 69) in deciding a motion for summary judgment. But neither may they "rely merely upon bare assertions, conclusory allegations or suspicions." *Fireman's Ins. Co.* v. *DuFresne*, 676 F.2d 965, 969 (3d Cir. 1982). To defeat summary judgment, appellants must set forth "*significant probative* evidence tending to support the complaint." *Anderson* v. *Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986) (emphasis added, internal quotations omitted). And summary judgment is "properly regarded not as a disfavored procedural shortcut, but rather as an integral part of the Federal Rules as a whole, which are designed to secure a just, speedy and inexpensive determination of every action." *Celotex*, 477 U.S. at 327.

ARGUMENT

I. THE DISTRICT COURT CORRECTLY HELD THAT APPELLANTS FAILED TO ADDUCE SUFFICIENT EVIDENCE OF LOSS CAUSATION

Applying the principles of *Robbins* v. *Koger Properties, Inc.*, 116 F.3d 1441 (11th Cir. 1997) – which this Circuit embraced in *Semerenko*, 223 F.3d at 185 – the court found that there was no triable issue of fact on the element of loss causation because there simply is no evidence that the price of IKON stock "'dropped in response to the disclosure of the alleged misrepresentations.'" 131 F. Supp. 2d at 687 (quoting *Semerenko*, 223 F.3d at 186). That holding is plainly correct: Appellants utterly failed to meet the governing standard under *Robbins* and *Semerenko* for proving loss causation; and their efforts to distinguish those cases – or, failing that, to persuade this Court to abandon those cases – are unavailing.

A. Applying The Principles Of *Robbins* and *Semerenko*, The Trial Court Correctly Held That Appellants Failed To Adduce Sufficient Proof That The Price Of IKON Stock "Dropped In Response To The Disclosure Of The Alleged Misrepresentations"

1. "To prove causation in the Third Circuit, a plaintiff *must* show both: (1) that he or she 'purchased a security at [a] market price that was artificially inflated due to a fraudulent misrepresentation,' and (2) 'that the artificial inflation was actually "lost" due to the alleged fraud,' that is, that the stock price 'dropped in response to disclosure of the alleged misrepresentations.'" 131 F. Supp. 2d at 687 (quoting *Semerenko*, 223 F.3d at 184, 186) (emphasis in original). To meet the second part of the test, it is not sufficient to show merely that the stock price fell at some point after the fraudulent misrepresentation was made; rather, "[w]here the value of the security does not actually decline *as a result of* an alleged misrepresentation, it cannot be said

that there is in fact an economic loss attributable to that misrepresentation." *Semerenko*, 223 F.3d at 185 (emphasis added).

Robbins, which this Court has embraced as "instructive of this point" (*Semerenko*, 223 F.3d at 185), establishes that there must be a direct and specific relationship between the *disclosure* of the misrepresentation and the *decline* in the stock price. In that case, Koger Properties, a commercial real estate company, announced on October 1, 1990, a drastic reduction in its quarterly dividend payment after Standard and Poor's downgraded the company's credit rating "in light of the deteriorating real estate environment." 116 F.3d at 1445. Koger's common stock price immediately fell by more than 50%. Sometime *after* that announcement and the drop in the stock price, "it was discovered that the [1988, 1989, and 1990] audited financial statements were false." *Ibid*. Following this discovery, Koger publicly announced a charge of more than $100 million to its balance sheet – the so-called "corrective disclosure." *Ibid*.

Not surprisingly, a class of investors brought suit under Section 10(b) against the company's auditors, Deloitte & Touche, alleging that the class members had "suffered damage when they purchased [Koger] stock . . . because the price of the stock was 'artificially inflated' as a result of Deloitte's clean audit opinions on the incorrect financial statements." *Ibid.* As evidence of loss causation, the plaintiffs' expert testified that Koger "would have had to cut its dividends at the beginning of the class period had [the] financial statements been corrected" and that the damages could be measured by "the decline in the price of [Koger] stock that occurred after the October 1990 dividend cut." *Ibid*. At the close of the evidence, Deloitte moved for judgment as a matter of law, arguing that, because the only decline in the company's stock had occurred *prior* to the "corrective disclosure," there was no loss causation. The district court denied the motion, and the jury returned an $81 million verdict against Deloitte. *Id*. at 1446.

The Eleventh Circuit reversed. The court began by noting that, to establish loss causation, plaintiffs must show that the alleged misrepresentation "was in some reasonably direct, or proximate, way responsible for [the] loss." *Id*. at 1447 (quoting *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983)). Thus, even "[i]f the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule [10b-5] is not permitted." *Robbins*, 116 F.3d at 1447. In the case before it, the court of appeals observed, the plaintiffs "may have offered sufficient evidence for a reasonable jury to conclude that Deloitte's misrepresentations artificially inflated the price of [Koger's] stock during the class period. This showing of price inflation, however, does not satisfy the loss causation requirement." *Id*. at 1448. As the court noted, the plaintiffs had "offered no evidence of a connection between Deloitte's misrepresentations and the decline in price of [Koger's] stock throughout the class period or following the October 1990 dividend cut. . . . Instead, plaintiffs simply claim they paid too much." *Ibid*. Indeed, when Standard and Poor's announced its concern about the "deteriorating real estate market" and the company's stock price dropped, "the investing public continued to believe that [Koger's] cash flow figures were correct and that [it] would not have to adjust its balance sheet to cover any past errors." *Ibid*. Because there was no "proof of a causal connection between [Deloitte's] misrepresentation and the investment's subsequent decline in value," the plaintiffs had "failed to support an essential element of their 10b-5 claim, loss causation." *Id*. at 1448-49.

In *Semerenko*, this Court adopted the loss causation principles of *Robbins*. Reviewing the trial court's disposition of a motion to dismiss in a Section 10(b) case, the Court explained that proving merely that the stock price was "artificially inflated" due to alleged fraud is insufficient: "[W]e are persuaded that an investor must also establish that the alleged misrepresentations proximately caused the decline in the security's value to satisfy the element of loss causation." 223 F.3d at 185. Applying that standard, the Court found the complaint sufficient at the pleadings stage, precisely because plaintiffs had alleged that the price of the stock at issue had "dropped in response to disclosure of the alleged misrepresentations." *Id*. at 186.

2. Judge Katz faithfully applied these principles and found appellants' proof woefully deficient. The trial court's first task was to discern precisely when, according to appellants, the alleged misrepresentation was "disclosed." As framed in the complaint, appellants' loss causation theory appeared to be that the "disclosure" occurred on August 14, 1998, when IKON issued a press release announcing $110 million in charges. See 131 F. Supp. 2d at 687 n.7; J.A. 112 (2d Am. Cplt. ¶ 97). But appellants beat a hasty retreat from that theory – because, as they now concede (see 131 F. Supp. 2d at 687), IKON's stock price did *not* "drop[] in response to [this] disclosure." *Semerenko*, 223 F.3d at 186. Indeed, as appellants' experts acknowledged, whereas IKON's stock price *declined* between April 22 and August 13, 1998 (the day *before* the "corrective disclosure"), it *increased* from $9.31 to $9.94 a share on August 14, 1998, the first trading day *after* the disclosure. See J.A. 1341, 1344 (Jarrell Rpt. ¶¶ 44, 55). Thus, IKON's August 14, 1998 press release obviously provided no basis for a finding of loss causation.

Appellants next proffered two new, but utterly contradictory, theories of loss causation, each backed by a different "damages expert." First, relying on Professor Jarrell, they contended that news of the alleged fraud was effectively "leaked" to the market *before* August 14, and that the market had fully absorbed the impact of the purported misrepresentations before the announcement of the accounting charges. See J.A. 2523-24 (Jarrell Dep. 223-24). At the very same time, relying on their *second* damages expert, R. Alan Miller, appellants contended (S.J. Opp. at 61) that exactly the opposite was true: the market, although "slightly relieved" immediately after absorbing the new information disclosed in the August 14 announcement, inexplicably reconsidered its initial positive reaction and began to bid the stock price down *after* the announcement of the accounting charges.[7]

Appellants have now decided to cast their lot with Jarrell; Miller rates hardly a mention in their brief. According to Jarrell, there were three "event windows" prior

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[7] Flatly disagreeing with Professor Jarrell's opinion, Miller testified that the information disclosed on August 14 had *not been anticipated by the market*. J.A. 2646 (Miller Dep. 431. To the contrary, he said, loss causation was established because there was a "decline in stock price which occurred *after* the August 14, 1998 announcement." Aff. of R. Alan Miller ¶ 19 (Ex. A. to Pl. Opp. to Motion *in limine* to Exclude Irrelevant and Inadmissible Damage Estimates) (emphasis added). Although Miller did not dispute that the stock price *rose* in the immediate wake of the August 14 announcement, he contended that the stock price fell in response to the announcement in the subsequent days and weeks. J.A. 2646 (Miller Dep. 426-27). That theory, of course, contradicts appellants' fraud-on-the-market theory of reliance, which presupposes that the "market for IKON securities was at all times an efficient market," and that, accordingly, "[t]he market price of IKON securities reacted efficiently to new information entering the market." J.A. 68-69 (2d Am. Cplt. ¶ 15). See *Oran* v. *Stafford*, 226 F.3d 275, 282 (3d Cir. 2000) (in an efficient market, "information important to reasonable investors is immediately incorporated into the stock price") (ellipses omitted).

to August 14, 1998, in each of which IKON ostensibly "leaked" news relating to the fraud, which in turn resulted in a drop in the stock price. These "event windows" occurred on April 22, June 29 through 30, and July 27 through August 17. J.A. 1340-1346 (Jarrell Rpt. ¶¶ 39-61); see 131 F. Supp. 2d at 688. See Exhibit A (J.A. 5562), attached hereto.

It is not hard to come up with "windows" of time during which the price of any publicly traded stock dropped, and IKON's stock price did drop in each of these three time frames. But the trial court correctly concluded that there was no evidence that these price drops occurred "in response to disclosure of the alleged misrepresentations." 131 F. Supp. 2d at 687. The first event window was April 22, 1998, when IKON announced that its second quarter earnings would be $0.35 per share, rather than the $0.38 per share that analysts had expected. J.A. 1340 (Jarrell Rpt. ¶ 41). The stock fell by $9.37 that day, from $34.62 to $25.25. *Id.* at 1341 (¶ 44). But as the trial court noted, the stock drop on April 22 was not precipitated by any announcement of the alleged fraud, or even of charges related to accounting issues. Rather, the price of IKON stock fell because of "issues related to the transformation *i.e.*, IKON's aggressive merger and acquisition initiative, competitive pressures, and costs associated with product rationalization." 131 F. Supp. 2d at 689 (internal brackets omitted).[8]

Jarrell's second window "was triggered by an announcement of lower-than-expected third quarter earnings on June 26, 1998." *Id*. at 689. On the next trading day, June 29, 1998, the stock declined $6.75 to close at $15.31 per share. J.A. 1342 (Jarrell Rpt. ¶ 47). But again, the accounting issues that constitute the alleged fraud in this case had no role in causing the stock price drop. Rather, as stated in a June 30 analyst report cited by Professor Jarrell, the drop resulted from "the same factors that led to the 2Q earnings shortfall, namely weak equipment sales amid tough competition from bigger industry rivals . . . and problems associated with integrating and absorbing recent acquisitions." 131 F. Supp. 2d at 689 (quoting Jarrell Rpt. ¶ 48, J.A. 1342). Finally, Jarrell observed that from July 27, 1998 to August 3, 1998, at the beginning of his third "event window," IKON's stock declined from $13.1875 to

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[8] Jarrell himself testified that the market

> learned in the April announcement that the company was having problems with, among other things, managing and getting the synergistic benefits and integrating these many, many companies that they had been acquiring.

131 F. Supp. 2d at 689 (quoting J.A. 2477 (Jarrell Dep. 37-38)). And appellants likewise concede that the April 22 "disclosure" cited "transformation issues" and "competitive pressure" (Br. 58), without mentioning accounting problems, income overstatement, or potential charges.

$10.125 per share. J.A. 1343 (Jarrell Rpt. ¶ 51). Once again: Not a whisper about accounting concerns, overstated income, or a fraudulent audit opinion.[9]

The trial court scrupulously examined the evidence proffered by appellants to carry their burden under *Robbins* and *Semerenko*. But as to each "event window" identified by Jarrell, the court found no evidence to suggest that the price of IKON stock had dropped due to any revelation of the purported fraud. Rather, the court explained, each of the identified disclosures "focused on factors such as the transformation initiative, rough competition, and weak sales, *and not on the alleged accounting misstatements or income inflation*" (131 F. Supp. 2d at 689, emphasis added). Even appellants are constrained to acknowledge that the "announcements during the period April 22, 1998 through August 14, 1998" concerned "*IKON's ongoing operations*." Br. 57 (emphasis added). The trial court was thus entirely

[9] During his deposition, Professor Jarrell identified three more disclosures outside of his "event windows" that he claimed were related to the alleged fraud. In his view (J.A. 2487-91; 2523-24), reports issued by securities analysts on May 27, July 6, and July 9, 1998 also "leak[ed]" news of the alleged 1997 fraud to the market, which, according to Jarrell, "support[s] the idea that the market anticipated charges during the spring and summer of 1998." 131 F. Supp. 2d at 691 (citing J.A. 2486; 2483 (Jarrell Dep. 75, 64-65)). As the court concluded, neither the July 6 nor the July 9 report could support a finding of loss causation since neither of them "coincided with any loss at all, which undermines the notion that the anticipation of charges caused any of the loss of which plaintiffs complain." 131 F. Supp. 2d at 691. Moreover, nothing in the May 27, 1998 report by Salomon Smith Barney (entitled, "Could More Cost-Cutting Be in the Cards?") remotely suggests concerns about accounting issues, nor do appellants suggest otherwise.

correct in refusing to credit Professor Jarrell's assertion "that a link exists between the loss and the alleged misstatements." 131 F. Supp. 2d at 688. See *ibid*. (appellants' expert testimony "show[s] that the plaintiffs' loss was caused by problems unrelated to the misstatements").[10]

3. Casting about in a sea of inhospitable facts, appellants offer two additional strategies by which to satisfy the loss causation standard articulated in *Robbins* and *Semerenko*. Neither is convincing.

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[10] Because there was no statistically significant market reaction to any disclosure that directly related to the substance of the alleged fraudulent misstatement by E&Y, the district court's holding should be affirmed for the additional reason that the alleged misrepresentation is immaterial as a matter of law. As this Court has held,

> when a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm's stock. Because in an efficient market "the concept of materiality translates into information that alters the price of the firm's stock," if a company's disclosure of information has no effect on stock prices, "it follows that the information disclosed . . . was immaterial as a matter of law."

Oran v. *Stafford*, 226 F.3d 275, 282 (3d Cir. 2000) (quoting *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997)). This Court in *Oran* "looked to the movement in the price of [the company's] stock following [the corrective] disclosure to determine if the information was material" for purposes of Rule 10b-5. 226 F.3d at 283. As it turned out, the "disclosure had no appreciable negative effect on the company's stock price." *Ibid*. To the contrary – and just as in this case – the share price actually *rose* after the corrective disclosure, a fact that this Court held was "dispositive of the question of materiality." *Ibid*.

a. First, appellants assert that the trial court "failed to perceive the precise nature of the fraud." As it now turns out, the "precise" "fraud" in this case is *not* about issuing a false audit opinion, or even about inflated income, false financial statements, or accounting irregularities. Rather, as appellants now formulate it, the "precise" "fraud" in this case was covering up the fact that "IKON's ongoing or normal earnings power was vastly overstated." Br. 78-79. When "the truth" about IKON's "earnings power" became "manifest" in 1998, the stock price dropped, thus satisfying the *Robbins* standard. Since the alleged fraud "covered up" lower "earnings power," and since the 1998 announcements revealed lower "earnings power," appellants conclude that it was, after all, the disclosure of the fraud that resulted in the drop in IKON's stock price. In effect, appellants claim that so long as the alleged fraud (a false audit opinion) relates at some level of generality to lower "earnings power," and the subsequent disclosures likewise relate at some level of generality to lower "earnings power," then the *Robbins* standard has been met.

But, as the trial court correctly explained, that argument satisfies the rule in *Robbins* only by denuding it of any conceivable meaning. Indeed, as Judge Katz observed, appellants' argument is the *very* argument advanced without success by the plaintiffs in *Robbins* (131 F.Supp. 2d at 690):

> [T]he plaintiffs' theory is the same as that in *Robbins*, where the plaintiffs claimed that the loss associated with the dividend cut exposed

> the true value of the stock and thus corrected the inflation caused by the fraud, even though there was no evidence that the market recognized any relationship between the dividend cut and the fraud. See *Robbins*, 116 F.3d at 1448. In this case, as in *Robbins*, it is not sufficient to show inflation caused by a misrepresentation and subsequent loss; the determinative factor is that there is no evidence that the alleged misstatements caused the loss, as opposed to or in addition to other factors.

If appellants' position were the law, the *Robbins* case would have come out the other way. In *Robbins*, as we noted above, plaintiffs contended that they purchased stock at an inflated price because of misrepresentations in Koger's financial statements; yet the stock price fell only after a dividend cut was announced. In an effort to demonstrate a nexus between the alleged fraud and the drop in the stock price, plaintiffs' expert testified that Koger "would have had to cut its dividends at the beginning of the class period had [its] financial statements been corrected to eliminate the incorrect statements of cash flow." 116 F.3d at 1445. Although both the misstatements in the financial statements and the later dividend cut could have been characterized as relating to Koger's ability to pay dividends, the court found "misplaced" the "attempt to characterize this testimony as proof of loss causation." *Id.* at 1448 n.6. Because the market was unaware of the past errors in Koger's balance sheet when the stock price fell, the court ruled that plaintiffs had not demonstrated loss causation.

Until August 14, the market was unaware that IKON would be taking $110 million in accounting charges. As the trial court correctly noted, the disclosures between April 22 and August 13 upon which appellants rely concerned IKON's 1998 operating performance, and did not make the slightest mention that IKON would be taking accounting charges. Such disclosures simply do not meet the *Robbins* standard because they do not amount to a "*direct* causal link between the misstatement and the claimant's economic loss." *Huddleston*, 640 F.2d at 549 n.24 (emphasis added). Indeed, under appellants' "earnings power" theory, "Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission." *Id*. at 549.

b. Appellants also contend (Br. 80) that the evidence met the *Robbins* standard because on August 4, 1998 (although not at any earlier point in time) the company issued a press release relating to the subject matter of the alleged fraud, which precipitated a drop in the stock price. But this argument is based on a mischaracterization of the record and simply does not meet the legal test under *Robbins*.

For one thing, appellants inexplicably misquote, and therefore misconstrue, the text of the August 4 press release. The release did not "announce that [IKON] had *started* a full review of its operations," as appellants repeatedly assert. Br. 62, 80 (emphasis added). Rather, it stated (J.A. 1915) that IKON "is in the process of conducting the full review of operations *previously announced*." (emphasis added). That "previous[] announce[ment]" was made several weeks earlier, on July 9, when IKON first disclosed that it "is conducting a detailed operations and financial review." J.A. 1830.

The distinction is quite crucial – because, when IKON actually *announced* the financial review on July 9, the stock price (as the district court noted, 131 F. Supp. 2d at 691) *did not decline*; the July 9 announcement therefore cannot be said to have "caused any of the loss of which plaintiffs complain." *Ibid*. That is no doubt why appellants now elect to treat the *August 4* press release as if it had released the news that was in fact released, without market reaction, on *July 9*.

In any event, IKON's August 4 press release did not "disclose" the alleged fraud in this case. IKON stated only that it was continuing a previously announced review of its operations. As the case law makes clear, a public announcement does not "disclose" the "fraud" for loss causation purposes unless it actually "touches upon" the fraud allegations. *Huddleston*, 640 F.2d at 549. And a plain vanilla statement that an internal review remains "in . . . process" hardly meets that standard.

Consider, by way of contrast, the disclosures found sufficient to prove loss causation in *Worlds of Wonder Sec. Litig.*, 35 F.3d 1407 (9th Cir. 1994). There, the plaintiffs alleged that Deloitte & Touche had given a clean opinion on a toy manufacturer's financial statements that (i) improperly recognized revenue on certain 1987 sales for which the company had offered price protection; (ii) improperly recognized revenue on a sale to K-Mart in which the company had to make certain concessions, including guaranteed sales; and (iii) improperly failed to account for the company's excess and obsolete inventory. *Id*. at 1422-23. The company later disclosed large losses, which included (i) a $13.2 million reserve for price protection in connection with the 1987 sales; (ii) a $9.9 million charge for K-Mart's cancellation of sales; and (iii) the creation of a $12 million inventory reserve. The stock price promptly declined. Each of the three disclosures preceding the stock decline "directly related" – in the court's words – to the allegation of fraud. *Id*. at 1422.

The August 4 press release falls at the opposite end of the spectrum. Bereft of anything that "touch[ed]" upon or "directly related" to the alleged fraud, appellants are left simply to speculate that "the market knew that something was wrong" (Br. 62) on August 4. But such untethered guesswork does not meet the summary judgment standard: "*significant probative* evidence tending to support the complaint." *Anderson*, 477 U.S. at 249 (emphasis added, internal quotations omitted). And guesswork is all appellants offered Judge Katz. As their lead expert acknowledged in an unguarded moment in his deposition, only "God knows" what information was actually being conveyed to the market about IKON's prospects. J.A. 2485 (Jarrell Dep. 70). Before plaintiffs should be permitted to roll the dice with a jury, seeking hundreds of millions of dollars, they should have *proof* of loss causation, not merely some fanciful notion that "something is wrong" but only "God knows" what.

B. Appellants Offer No Persuasive Reason To Distinguish Or Abandon The Loss Causation Principles Of *Semerenko* And *Robbins*

Burdened by unavoidable facts and controlling case law, appellants ask this Court either to distinguish the governing cases or abandon them. Neither option is appropriate.

1. *Robbins* is not distinguishable

Appellants contend that there is a "stark distinction between [*Robbins*] and the present case" that precludes summary judgment. In *Robbins*, appellants note, the plaintiffs "made no claim and presented no evidence that the decline associated with the dividend cut announcement was related to the accounting misstatements." Br. 84. In *this* case, by contrast, appellants' expert "*asserts* that a link exists between the loss and the alleged misstatements." *Ibid*. (emphasis added).

But as the district court observed, to avoid summary judgment, it is not enough for appellants simply to *say* that the stock price fell in response to a corrective disclosure; they must adduce *evidence* – and sufficient evidence, at that – to support such a finding:

> [I]t remains plaintiffs' burden under *Semerenko* to provide evidence supporting a reasonable inference that such disclosures were in fact made, and that they were a proximate cause of loss.

131 F. Supp. 2d at 687. And as the court could not help but conclude, Professor Jarrell's assertion of a "link" between E&Y's alleged misstatement in 1997 and the drop in IKON's stock price in 1998 is "not supported by any evidence, but rather, the analysts' reports and the expert testimony show that the plaintiffs' loss was caused by problems unrelated to the misstatements." *Id*. at 688. See also *id*. at 689 ("[n]either analysts' reports nor plaintiffs' expert analysis indicate that the stock decline was caused by anything other than business conditions and operational and management problems").

Since Professor Jarrell's bare assertion is "not supported by any evidence," appellants' argument boils down to this: summary judgment cannot properly be granted if one of the nonmovant's experts *asserts* that summary judgment is not warranted. The law, of course, is to the contrary. See *id*. at 688-689 (citing *Brooke Group Ltd.* v. *Brown and Williamson Tobacco Corp.*, 509 U.S. 209, 242 (1993) (summary judgment appropriate if an expert opinion is not supported by sufficient facts, or if indisputable facts on the record contradict opinion or otherwise render it unreasonable); *In re Apple Computer Sec. Litig*., 886 F.2d 1109, 1116 (9th Cir. 1989) (summary judgment appropriate if the evidence is clear and contrary to the expert's opinion)). As the courts have made clear, "[a]n expert's opinion that lacks any credible support does not create an issue of fact." *American Key Corp.* v. *Cole Nat'l Corp.*, 762 F.2d 1569, 1580 (11th Cir. 1985).

The Court should be particularly reluctant to allow an expert's "assertion" to substitute for record evidence in this case, where appellants had two experts at the ready to make inconsistent and mutually exclusive "assertions." As discussed above, Mr. Miller testified in deposition that Professor Jarrell is *wrong* about his "leakage" theory; Miller's opinion is that "the information disclosed on August 14 had *not* been anticipated by the market." J.A. 2646 (Miller Dep. 431) (emphasis added). Thus, not only is Professor Jarrell's "leakage" theory "not supported by any evidence" (131 F. Supp. 2d at 688), it is flatly contradicted by expert testimony sponsored by appellants themselves. That is hardly the "significant probative evidence" (*Anderson*, 477 U.S. at 242) that is required to defeat a motion for summary judgment.

2. ***Robbins*, as adopted by *Semerenko*, remains the governing law in this Circuit, and appellants offer no good reason to abandon it**

Appellants chastise the trial court for applying the "formulaic" approach of *Robbins* instead of the "practical" (and presumably more fluid) approach to loss causation set forth in this Court's *EP Medsystems* case. That claim is meritless. For one thing, *EP Medsystems*, as the district court held (131 F. Supp. 2d at 690 n.10), is entirely consistent with *Robbins* and this Court's adoption of *Robbins* in *Semerenko*. Indeed, far from criticizing the decision in *Semerenko*, the Court in *EP Medsystems* cited that case with approval. 235 F.3d at 883-84. Like *Robbins* and *Semerenko*, *EP Medsystems* "employed a proximate cause standard." 131 F. Supp. 2d at 690 n.10. Moreover, the decision in *EP Medsystems* "confirms that the Third Circuit's practical approach still requires 'sufficient causal nexus between the loss and the alleged misrepresentation,' and 'limits the ability of plaintiffs to recover for losses sustained on the basis of factors unrelated to any misrepresentation or fraud.'" *Ibid*. (quoting *EP Medsystems*, 235 F.3d at 883-884).

In any event, *EP Medsystems*, by its terms, dealt only with the unusual case in which a plaintiff was induced by "personal communications" with the defendant's "executives" to make an investment in the company. It expressly did *not* address "the usual securities action," in which "plaintiffs complain because some announcement emanating from the company, whether regarding a tender offer, earnings, projected earnings, or the company's financial condition, fraudulently represented the actual state of affairs." 235 F.3d at 884 (citations omitted). It is, of course, the latter context that is at issue in the present case – and in that setting, as *EP Medsystems* makes clear, the rule in *Semerenko* controls. See *ibid*. (citing *Semerenko* as governing "the usual securities case").[11]

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[11] Appellants' reliance (Br. 85-86) on two Second Circuit cases, *AUSA Life Ins. Co.* v. *Ernst & Young*, 206 F.3d 202 (2d Cir. 2000), and *Suez Equity Investors, L.P.* v. *Toronto-Dominion Bank*, 2001 WL 487111 (2d Cir. May 8, 2001), strays even farther afield. In its most recent statement on the issue, that Court acknowledged that it had issued "somewhat inconsistent precedents on loss causation." *Suez Equity Investors*, 2001 WL 487111 at *6 n.1. But, far from rejecting the loss causation standard applied by this Court in *Semerenko*, the Second Circuit spoke approvingly of cases in which the reasoning of *Robbins* and *Semerenko* was applied:

> We note that the approach of the Seventh Circuit – inquiring whether the loss at issue was caused by the materialization of a risk that was not disclosed because of the defendant's fraud – appears to be both principled and predictable. See *Bastian* v. *Peteren Res. Corp*., 892 F.2d 680, 685-86 (7th Cir. 1990); see also *Caremark, Inc.* v. *Coram Healthcare Corp*., 113 F.3d 645, 648 (7th Cir. 1997) ("To plead loss causation, the plaintiff must allege that it was the very facts about which the defendant lied which caused its injuries.").

Ibid.

It must be added that appellants completely misstate (Br. 85) the holding in *AUSA Life*, 206 F.3d 202. In that case, the panel produced three separate opinions on the loss causation issue: one to *affirm* the district court's judgment that there was no evidence of loss causation (see 206 F.3d at 225 (Jacobs, J., concurring)); one for reversal (*id*. at 228 (Winter, C.J., dissenting)); and one for a remand for additional findings on "the foreseeability component of the proximate cause inquiry." *Id*. at 217 (opinion of Oakes, J.). The panel ultimately vacated and remanded only because Judge Jacobs, in spite of his conclusion "that the district court's findings demonstrate the absence of loss causation," nonetheless "shifted [his] vote . . . from affirmance, to vacatur with a remand for further findings . . . [i]n order to allow the Court to issue a mandate." 206 F.3d at 225. On remand, the district court concluded that plaintiffs' losses were not "a foreseeable result of E&Y's certification of JWP's annual reports" and again entered judgment for E&Y. *AUSA Life Ins. Co.* v. *Ernst & Young*, 119 F. Supp. 2d 394, 404 (S.D.N.Y. 2000).

Finally, there is no basis for appellants' professed alarm (Br. 87) that retaining the rule in *Semerenko* would "present an [i]nsurmountable bar to the maintenance of any and all securities actions" or spell the end of the "enforcement of private securities actions in this Circuit." Appellants seem to believe that, under *Semerenko*, only an outright confession of fraud can constitute a "corrective disclosure"; and in appellants' view, no company would ever make so bold an admission. But *Semerenko* imposes no such standard. In the present case, for example, E&Y has never disputed that the August 14 disclosure – which hardly constitutes an outright admission of fraud – was nevertheless an entirely sufficient "disclosure" for loss causation purposes: it was specifically addressed to accounting issues that, according to appellants, improperly inflated the purchase price of the stock at year-end 1997; it thus "directly related" to, and "touch[ed] upon," the basic allegations of the fraud. Unhappily for appellants, the price of IKON stock did not drop in response to that disclosure. But that does not mean that *Semerenko* imposes an insurmountable standard for proving loss causation; it simply means that appellants' losses *were not caused* by the alleged misrepresentations that underlie their claim.

What is more, there is not the slightest logic to appellants' worry that crafty defendants – spurred on by *Semerenko* – will, in an effort to camouflage their fraud, "[k]nock down the stock price" and "tak[e] out at least some of the inflation" by issuing "adverse information that does not appear related to . . . previous misstatements." Br. 10. Companies have nothing to gain, and everything to lose, by damaging their stock price through "leaks" of bad news that are unrelated to the alleged fraud. By doing so, they will drive down their stock price, while leaving that reduced price vulnerable to further drops if and when the fraud is ultimately disclosed. Moreover, if the cover story is itself false, releasing such a leak to the public is likely to constitute an independent act of securities fraud. In short, appellants' claim that the "sky is falling" – and that settled precedent must therefore be abandoned (a step that a panel of this Court is not free to take anyway, see, *e.g.*, *United States* v. *Hodge*, 211 F.3d 74, 78 n.5 (3d Cir. 2000)) – blinks reality, as well as doctrine.

II. THE DISTRICT COURT CORRECTLY HELD THAT THERE IS NO TRIABLE ISSUE OF FACT WITH REGARD TO SCIENTER

A. To Establish The Element Of Scienter, Appellants Must Show That E&Y Made Either A "Knowing" Or "Reckless" Misrepresentation – Each Of Which Imposes An Extraordinarily High Threshold Of Proof

To prevail in a securities fraud action, a plaintiff must establish that the defendant made a material misstatement of fact, and that it did so with scienter. *Semerenko*, 223 F.3d at 174. E&Y made only one public statement during the class period: its "clean" audit opinion on IKON's 1997 year-end consolidated financial statements. Br. 10. To warrant a jury trial, therefore, appellants were required to amass proof sufficient to show, not only that E&Y's audit opinion was false, but that E&Y issued that false opinion with "a mental state embracing an intent to deceive, manipulate or defraud." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

1. Although appellants insist that the record "raises a strong inference of scienter" (Br. 68), they do not identify the legal standard by which scienter is measured. And small wonder – for, as the trial court correctly held, it is a standard that appellants come nowhere close to meeting. It may even be that appellants misapprehend what the governing standard is. For example, they assert that, with regard to about $20.8 million of the alleged errors, E&Y was not merely "reckless," but in fact acted with "actual knowledge."[12] Br. 6, 20. Appellants' theory appears to be that because E&Y "knew" of certain facts (on which appellants' experts now rely in claiming $54.9 million in putative "errors"), and because E&Y "knew" that there were risks of misstatement if IKON failed to take particular steps, E&Y must

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[12] Appellants state (Br. 20) that $20.8 million – which constituted about 10% of IKON's pre-tax income – was "double the amount that E&Y indisputably, and in writing, deemed to be material." But the document appellants cite (J.A. 309) deals with "planning materiality" – the threshold used by E&Y auditors in planning the scope of the 1997 IKON audit. As the uncontradicted testimony shows, that threshold is deliberately set lower than the amounts that would be judged to be material to the financial statements. J.A. 394 (Nepa Dep. 183-85); J.A. 4090-91 (Mulherin Dep. 78-82). There is, in fact, no evidence that 5% was material for financial statement purposes.

therefore have "knowingly" issued a false audit opinion on the financial statements. Br. 20-27.

It is best to put this canard to rest at the outset. To act "knowingly" within the meaning of the case law, an auditor must know that its *audit opinion* is false; it is not enough simply to "know" some underlying facts that increase the risk that an audit client's financial statements might be misstated. "In order to establish intentional deception, a plaintiff must do more than show that the defendant had knowledge of the undisclosed facts." *Danis* v. *USN Communications, Inc.*, 121 F. Supp. 2d 1183, 1193 (N.D. Ill. 2000). As this Court explained in *McLean*, the scienter element requires a plaintiff to prove "knowledge not only of the facts withheld, but also of the risk that the buyer or seller will be thereby misled." 599 F.2d at 1202. Accord *Danis*, 121 F. Supp. 2d at 1193-94 (granting summary judgment for Deloitte & Touche; "plaintiffs contend that Deloitte knew about misrepresentations in USN's financial statements because Deloitte knew about problems in USN's operational systems . . . . Even if this knowledge could be established, it would merely support an inference of negligence"); *Worlds of Wonder*, 35 F.3d at 1426 ("Deloitte knew many facts because it did a diligent audit. But the issue is not whether Deloitte knew facts about transactions; it is whether Deloitte had 'actual knowledge' of a misrepresentation."); *Schlifke* v. *Seafirst Corp.*, 866 F.2d 935, 946 (7th Cir. 1989) (with regard to establishing scienter, "[t]he question is not whether the [defendant] had knowledge of undisclosed facts").

2. Appellants do not contend that E&Y actually "knew" that its audit opinion was false.[13] And it may even be that appellants make the suggestion of "actual knowledge," not because they actually believe it, but because they hope that "recklessness" will seem, by contrast, an easier standard to meet. But that is simply not the case: this Circuit, faithfully applying the Supreme Court's ruling in *Hochfelder*, 425 U.S. at 193 n.12, has emphatically held that "recklessness" is an extraordinarily exacting standard in its own right – requiring significantly more than negligence, or even egregious negligence. "Recklessness" – in the specific context of auditor liability under Section 10(b) – "may be defined as . . . an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *McLean*, 599 F.2d at 1197; see also *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 540 (3d Cir. 1999) (affirming district court's dismissal of securities fraud complaint because "[p]laintiffs' allegations, even if true, would not demonstrate an 'extreme departure' from the standards of ordinary care").

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[13] E&Y contends, of course, that its audit opinion was not false at all – but moved for summary judgment on scienter grounds only.

Recklessness, in short, is "relatively close to intentional misconduct." *Healey* v. *Catalyst Recovery of Penn., Inc.*, 616 F.2d 641, 649 (3d Cir. 1980). As this Court summarized the point in *McLean*, recklessness is "a conscious deception or . . . a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception." 599 F.2d at 1192 (internal quotations and citations omitted).

The Court applied these principles in *McLean*, reversing the trial court's judgment against an auditing firm precisely because the plaintiffs had not established recklessness. The Court explained that "the issue is whether the defendants had an honest belief that the statements made by them are true. If they did have that honest belief, *whether reasonably or unreasonably*, they are not liable." 599 F.2d at 1198 (internal quotations omitted, emphasis added). Accordingly, the Court held, plaintiffs must make a "*showing of shoddy accounting practices amounting to at best a pretended audit or of grounds supporting a representation so flimsy as to lead to the conclusion that there was no genuine belief back of it*." *Ibid*. (emphasis added).

Case law elsewhere is just as exacting. In *Worlds of Wonder*, *supra*, for example, the Ninth Circuit affirmed the grant of summary judgment for an auditing firm, notwithstanding the testimony of plaintiffs' expert that the company's financial statements violated GAAP and that the auditor had conducted the audit improperly. 35 F.3d at 1426. Echoing the standard in *McLean*, the court held that:

> the plaintiff must prove that the accounting practices were so deficient that the audit amounted to *no audit at all*, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that *no reasonable accountant would have made the same decisions if confronted with the same facts.*

Ibid. (internal quotations omitted, emphasis added).

Thus, even a showing that IKON's financial statements did not comply with GAAP, or that E&Y did not comply with GAAS, would not establish scienter. For one thing, "GAAP is not a set of rules ensuring identical treatment of identical transactions; rather, it tolerates a range of reasonable treatments." *In re Cirrus Logic Sec. Litig.*, 946 F. Supp. 1446, 1457 (N.D. Cal. 1996). "Allegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent, are not sufficient to state a securities fraud claim." *Chill* v. *General Elec. Corp.*, 101 F.3d 263, 270 (2d Cir. 1996) (affirming dismissal of complaint for failure to allege scienter). See also *Worlds of Wonder*, 35 F.3d at 1426 (allegations of violations of GAAS insufficient to establish scienter).

3. Mindful of how tough it is to prove recklessness – and recognizing, perhaps, that their suggestion of "actual knowledge" is really just a makeweight – appellants adopt three lines of attack. First, they invoke "the general rule that scienter is a

question for the jury." Br. 68. Judge Katz expressly recognized as much (131 F. Supp. 2d at 692), but noted as well that "summary judgment may be granted in appropriate cases" – in particular, those in which "the evidence presented permits only an inference of negligence, not of scienter." *Id*. (citing cases). As even appellants are constrained to admit (Br. 67), courts do, indeed, grant summary judgment on the element of scienter; and Judge Katz faithfully applied the governing standards in doing so here.[14]

Next, appellants accuse the trial court of making "factual findings" in E&Y's favor, notwithstanding the duty to draw all reasonable inferences in favor of the nonmovant. Br. 68-70. But Judge Katz did no such thing. Well aware of his obligation to view "all of the facts . . . in the light most favorable to . . . the non-moving party" (131 F. Supp. 2d at 686), Judge Katz recognized that he was equally obligated to *measure* those facts against the appropriate legal standard. Under the

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[14] Appellants assert (Br. 68) that the cases on which the trial court relied are "factually distinguishable." According to appellants, the Ninth Circuit upheld the grant of summary judgment on scienter grounds in *In re Software Toolworks*, 50 F.3d 615 (1994), and *In re Worlds of Wonder*, 35 F.3d 1407 (1994), only "because any inference of scienter in those cases was rebutted by other, <u>undisputed</u> evidence" (Br. 68 (emphasis in the original)). In fact, however, in each of those cases the plaintiff had proffered an accounting expert who opined – just as in this case – that scienter was present, notwithstanding the accounting firm's defenses. See *Software Toolworks*, 50 F.3d at 628; *Worlds of Wonder*, 35 F.3d at 1426-27. Nevertheless, the Ninth Circuit held that the evidence in each case did not satisfy the high threshold for recklessness. So here.

governing standard, the court observed, "[i]f the evidence is merely colorable, or is not significantly probative, summary judgment may be granted." *Ibid*.

Turning, finally, to a common yet desperate tactic, appellants proffer fully 65 pages of factual, and fact-like, material, doubtless in the hopes of persuading this Court that lurking somewhere must be a disputed material issue. But "[n]either sheer bulk, nor the existence of a disputed fact of one kind or another, necessarily suffices to defeat a summary judgment motion, for a 'genuine' issue does not exist unless record evidence would permit a reasonable factfinder to adopt the nonmovant's view." *Moore* v. *Nutrasweet*, 836 F. Supp. 1387, 1390 (N.D. Ill. 1993). On closer examination, appellants' allegations are like a "ketchup bottle": the argument "looks quite full, but it is remarkably difficult to get anything useful out of it." *Dartmouth Review* v. *Dartmouth College*, 889 F.2d 13, 18 (1st Cir. 1989).

As we show below, none of appellants' allegations, taken singly or together, measures up to the standard of recklessness under the case law. The trial court was therefore entirely correct in granting E&Y summary judgment for want of sufficient proof of scienter.

B. Applying The Governing Standards, The District Court Correctly Held That Appellants Had Failed To Adduce Sufficient Evidence Of Scienter

1. The scope and nature of the 1997 audit belie any suggestion that E&Y engaged in only a "pretended audit"

Although appellants refer periodically to alleged "misstatements" by E&Y, it bears reiterating that E&Y made only one statement at issue in this case – its audit opinion on IKON's consolidated, year-end 1997 financial statements. That statement, in relevant part, reads as follows: "In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of IKON Office Solutions, Inc. and subsidiaries at September 30, 1997 and 1996, and the consolidated results of their operations and their cash flows for each of the three years in the period ended September 30, 1997 in conformity with generally accepted accounting principles." J.A. 117-118 (2d Am. Cplt. ¶ 109). E&Y did not opine on any one district of IKON, such as the Southern District, or on any one account, such as accounts receivable reserves. It opined only on IKON's 1997 *consolidated* financial statements.

Appellants cannot *conceivably* prove at trial, as they would have to, that E&Y's work on the 1997 *consolidated* year-end audit amounted to "a pretended audit" or "no audit at all." As the trial court explained, "the general scope and nature of the audit work make it difficult to raise an inference of scienter, especially in light of the highly detailed documentary evidence of Ernst's procedures, calculations and findings, which Ernst itself produced in the course of its audit." 131 F. Supp. 2d at 704. It is simply undisputed – indeed, the entire subject barely surfaces in appellants' brief – that

E&Y's audit was remarkably comprehensive, spanning multiple business units and districts across the country.

E&Y began its planning procedures for the 1997 audit in March of that year, identifying and developing the scope of the work, coordinating worldwide services, and establishing a timetable for completing the audit. J.A. 5446 (Mulherin Decl. ¶ 7). In the course of planning the audit, E&Y's engagement team obtained an understanding of IKON's internal controls (*id*. at 5447 ¶¶ 8-10), and considered numerous other factors, including the results of prior years' audits, the results of internal audits of IKON, and business units considered by IKON management to be "risk" companies. *Id*. at 5447-48 ¶ 11.

At the conclusion of these extensive procedures, E&Y determined that, in addition to procedures performed at IKON's headquarters, E&Y would perform six full scope audits and eight "specific scope" audits at IKON's business units, representing fully 50% of the company's revenues. *Id*. at 5448 ¶ 12; 131 F. Supp. 2d at 703. In addition, while E&Y judged IKON's internal controls to be effective, it determined *not to rely* on them and instead performed "substantive" procedures (*i.e.*, extensive testing of account balances underlying IKON's consolidated financial statements) and analytical tests on the balances. Following a methodology recognized as appropriate under GAAS, E&Y performed some procedures as of the end of

IKON's third quarter (June 30, 1997), and rolled forward the results of those procedures based on more limited testing at the end of the fiscal year. J.A. 5450 (Mulherin Decl. ¶ 18).

Even after this extensive planning, however, E&Y's interim procedures identified issues that required further investigation and testing. In IKON's Northern California District, for example, the implementation of a new computer system made it difficult to audit the collectibility of accounts receivable. E&Y therefore declined to reach a conclusion on the district's reserve for doubtful accounts as of June 30, 1997, instead performing additional procedures on the existence and collectibility of accounts receivable at September 30, 1997. J.A. 5450 (Mulherin Decl. ¶ 18); J.A. 4778-82. (workpaper). In the end, this and other unbudgeted auditing work required E&Y to devote approximately 70 percent more than the budgeted hours to the audit of the Northern California District. J.A. 5451 (Mulherin Decl. ¶ 23); J.A. 3149, 4803-06 (workpapers). Similarly, in IKON's Southern District, E&Y personnel devoted 30 percent more hours than originally planned to the audit of that business unit. J.A. 3148 (workpaper). All told, although E&Y had budgeted a total of 8,250 hours to the IKON audit as a whole, the firm ultimately devoted more than *ten thousand* hours to the project. J.A. 3147 (workpaper).

A "pretended audit" (*McLean*, 599 F.2d at 1198)? "No audit at all" (*Worlds of Wonder*, 35 F.3d at 1426)? Nonsense.

2. The role and conclusions of Arthur Andersen belie any suggestion that E&Y engaged only in a "pretended audit"

In the summer of 1998, Arthur Andersen – another major national accounting firm and a fierce competitor of E&Y – was engaged at the direction of the IKON Board of Directors to provide an independent check on E&Y's work during the Special Procedures. At the end of its review, Andersen concluded that there was no reason to believe that the 1997 financial statements were materially misstated. Thus, although appellants now maintain that $54.9 million of the $110 million charge taken at the conclusion of the Special Procedures should have been recorded as of September 30, 1997, Andersen reviewed the charges and did *not* disagree with the allocation, nor did it disagree with IKON's decision not to restate the 1997 financial statements. J.A. 3188, 3191-92, 3195 (McAleer Dep. 153-56, 165-71, 181-83); J.A. 3259-60 (Costello Dep. 219-24). Andersen therefore reported to its client – the IKON Board of Directors – that it concurred that IKON's 1997 financial statements did not require restatement. Andersen firmly understood that it had been charged with notifying the Board if it disagreed with the allocation of the adjustments (J.A. 3188 (McAleer Dep. 153-56); J.A. 3260 (Costello Dep. 221-24)), and it recognized that the

Board expected the firm to express any disagreement it may have had. J.A. 3344 (Forese Dep. 89-92). Yet Andersen expressed no disagreement.

In the course of performing this review, moreover, Andersen thoroughly examined the workpapers produced by E&Y during the 1997 audit. J.A. 3184-85 (McAleer Dep. 139-44). Andersen partners and staff spent *hundreds* of hours performing this review. J.A. 3184 (McAleer Dep. 138-40); J.A. 3233 (Costello Dep. 113). While it is undisputed that Andersen's work did not constitute an "audit," the Andersen team nonetheless found nothing "that would be a significant issue" or "significant deficiency" regarding the quality of E&Y's work. J.A. 3185 (McAleer Dep. 142); J.A. 3256 (Costello Dep. 208). According to the Chairman of the Audit Committee of the IKON Board, Andersen gave E&Y a "passing grade." J.A. 3300 (Birle Dep. 109-110). Indeed, Andersen concluded that "[t]he balance sheet was solid" at September 30, 1997, and "it appeared from that review that the . . . reserves were not aggressive, they weren't conservative, they were essentially in the middle, solid." J.A. 3185 (McAleer Dep. 144); J.A. 3257 (Costello Dep. 210-12). Not only that, the principal hands-on Andersen partner on the engagement determined that, had he been in charge of the 1997 audit, he was "[n]ot sure we would do much differently given [the] scope and size of the company." J.A. 3258 (Costello Dep. 213-214). And the Andersen partner in charge of the engagement told George Berry, the E&Y partner responsible for the IKON audit, that E&Y had "done a fine audit" (J.A. 3062 (Berry Dep. 116)) – that "[t]here's nothing that . . . Arthur Andersen was aware of that was viewed to be a significant deficiency." J.A. 3256 (Costello Dep. 208).

In a case where appellants are required to show that "no reasonable accountant would have made the same decision if confronted with the same facts" (*In re Worlds of Wonder*, 35 F.3d at 1426), proof that Andersen – a "reasonable" accounting firm by anyone's lights – found no basis for disagreeing with E&Y's judgments is absolutely devastating. And appellants know it. That is why, from the get-go, they have sought refuge from the Andersen evidence – first filing a motion *in limine* to preclude reference to Andersen's work at trial (J.A. 211), and now seeking to minimize Andersen's work product. But appellants' suggestion (Br. 53) that "Andersen did not do enough work to give probative evidence" is flatly contradicted by the two lead partners from Andersen, who testified that they did quite enough work, and had all the requisite information, to advise the IKON Board. See J.A. 3269-70 (Costello Dep. 257-60); J.A. 3201 (McAleer Dep. 206-09).[15]

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[15] Appellants insert the claim that Andersen "did not do enough work" in the middle of a sentence that begins "The lower court correctly recognized that . . ." (Br. 53) – as if to suggest that Judge Katz actually concluded that Andersen's work was insufficient. The trial court in fact reached just the opposite conclusion. 131 F. Supp. 2d at 698-99.

Nor does it matter that "Andersen never approved any audit procedures or made any such GAAP or GAAS conclusions." Br. 71. What *does* matter – what assuredly moved appellants to try so hard to preclude the admission of the Andersen evidence at trial – is that Andersen, charged with acting as a "second pair of eyes" for the IKON Board (J.A. 3336 (Forese Dep. 59)), took a close look at everything E&Y did; expressed no disagreement with the allocation of charges at the end of the Special Procedures; and concurred in the decision not to restate the 1997 financial statements. As the trial court correctly concluded, no well-instructed jury, confronted with this evidence, could conclude that E&Y's work was so deficient as to constitute "a pretended audit." *McLean*, 599 F.2d at 1198.

3. Appellants' specific quarrels with the 1997 audit do not raise any triable issue of fact from which a jury could reasonably find that E&Y performed only a "pretended audit"

In the face of this extraordinarily comprehensive audit of an extraordinarily complex company, whose results were later concurred in by a second, prominent national accounting firm, how exactly do appellants hope to show that it was all just "pretended"? In two ways: first, by contending that E&Y should have done *even more* work once it was confronted by (i) allegations of potential wrongdoing by IKON and (ii) possible shortcomings in IKON's internal controls; and second, by identifying *certain* account balances at *certain* IKON districts that, in appellants' experts' view, should have been audited differently. Neither line of attack is the least bit persuasive.

a. Appellants first criticize (Br. 16-17) E&Y's response to an allegation – supposedly made by Peter Shoemaker, an IKON official, in early 1997 – that another IKON officer, Kurt Dinkelacker, was "cooking the books." Seemingly, no amount of contrary evidence will tire appellants of this argument. It is, after all, undisputed that Peter Shoemaker denied under oath that he even made the remark, denied that he believed the allegation to be true, and insisted that he had in fact been misunderstood. See 131 F. Supp. 2d at 695; J.A. 2988-91 (Shoemaker Dep. 7-23). It is likewise undisputed that George Berry, the E&Y partner responsible for the IKON audit, understood the remark (as everyone else did) to mean that Dinkelacker had been accused of improperly characterizing operational expenses as "transformation expenses" (see 131 F. Supp. 2d at 695; J.A. 3097 (Stuart Dep. 21-23); J.A. 3386A (Dinkelacker Dep. 10-12); J.A. 3048 (Berry Dep. 57-58); J.A. 1140-41 (Berry notes); J.A. 2988-91 (Shoemaker Dep. 7-23)); yet E&Y had just recently reviewed IKON's "transformation expenses" and found no such improprieties. See 131 F. Supp. 2d at 695, J.A. 3054 (Berry Dep. 81-84); J.A. 351 (Nepa. Dep. 10-11). Nor do appellants contend that there were any.

As if that were not enough, it is undisputed as well that Berry was told, in the very same conversation with Dinkelacker, that IKON had already engaged outside counsel (Ballard Spahr Andrews & Ingersoll, LLP) to investigate the allegation. It is undisputed that E&Y fully cooperated in the investigation. 131 F. Supp. 2d at 695, J.A. 3052, 3054 (Berry Dep. 76, 81-83).[16] And, as appellants acknowledge, Ballard Spahr "informed Mr. Berry that . . . there was nothing to the 'cooking the books' allegation." J.A. 5259-60 (Pl. Response to E&Y's First Set of Requests for Admissions).

Even with all that, appellants' experts believe that Mr. Berry should have done more to investigate the "cooking the books" allegation. Br. 16-17. They are entitled to think so – but they are not entitled to an audience with a jury. As the trial court correctly concluded: "Ernst did not fail to respond to the red flags it encountered, but [] it received reasonable assurances that the top management at IKON was informed of all potential problems and that all allegations received due investigation by outside counsel." 131 F. Supp. 2d at 694-95.

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[16] Appellants complain (Br. 16 n.5) that they were "prevent[ed] . . . from inquiring" into Ballard Spahr's investigation because IKON "asserted the attorney-client privilege with respect to the work of that law firm." That is just plain false. IKON initially asserted privilege, but the company later waived the privilege, and appellants explored the issue at length. See, *e.g.*, J.A. 2992 (Shoemaker Dep. 28-30); J.A. 3098-3100 (Stuart Dep. 25-38).

Appellants next claim (Br. 17-19, 43-44) that E&Y failed to adjust the scope of the 1997 audit to take account of certain risk factors that the firm had identified in planning the audit. In a pre-printed, 20-page checklist entitled "Internal Control and Fraud Considerations" (J.A. 1142-61), E&Y had noted the presence of two or three risks (among several dozen possibilities), including "unduly aggressive earnings targets" and "excessive interest in maintaining or increasing [IKON's] stock price or earnings trend."[17] It is odd, to say the least, that appellants seek to hold *against* E&Y the firm's diligent identification of risks in the audit planning stage – an identification

[17] Appellants assert that the checklist reflects E&Y's "conclusion that a significant risk of financial statement error existed." Br. 17. Not surprisingly, appellants do not identify the page of the document on which this "conclusion" appears – because it is entirely fictitious. As for appellants' suggestion that a handful of "yes" responses – on a checklist of risk factors that also contained 98 "no" answers – indicates the likelihood of "financial statement error," the instructions at the outset of this E&Y form make clear why that is not so:

> The relative importance of the risk factors varies among engagements from critical to insignificant. Some of the factors will be present in clients where the specific conditions do not present a weakness in internal control at the entity level or present a risk of material misstatement due to fraud, while in other situations they may. Accordingly, we exercise considerable professional judgment when considering the risk factors individually and in combination. When considering the presence of risk factors, we consider whether there are other factors or specific controls that mitigate or exacerbate the risk factors we have identified.

J.A. 1145.

that is prescribed, and largely defined, by the professional literature. See AU § 316. It is odder, still, to contend, as appellants do (Br. 19), that E&Y's explicit consideration of these risks in planning the audit "raises a strong inference of scienter." And, it need hardly be added, the case law confirms that an auditor's knowledge of management's desire to achieve strong earnings, without more, is insufficient to establish scienter. See *Software Toolworks*, 50 F.3d at 626 (although "management was under extraordinary pressure for favorable earnings," that fact, even coupled with other circumstantial evidence, was "insufficient to support an inference of scienter"); *Acito* v. *Imcera Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) (plaintiffs could not allege scienter simply by claiming that management wanted to maintain an inflated stock price because "[i]f scienter could be pleaded on that basis alone, virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions"); *Tuchman* v. *DS Communications Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994) (recognizing that motive to maintain high stock price is insufficient to establish scienter).

Appellants also contend that E&Y improperly relied on IKON's internal controls in performing its 1997 audit work. Br. 38-40. The evidence is undisputed, however, that although the planning of the audit appropriately included an analysis of internal controls – as the professional literature contemplates (see AU § 319) – E&Y's

"effective/not rely" audit approach focused instead on substantive testing of accounts. 131 F. Supp. 2d at 697 ("Ernst designed its audit procedures with the express purpose of avoiding reliance on failed internal controls."); J.A. 5450 (Mulherin Decl. ¶¶ 17-18). Moreover, it is not sufficient for a plaintiff to allege only that internal controls are deficient; the plaintiff must also allege that problems with internal controls actually resulted in material errors in a company's financial statements. See *Monroe* v. *Hughes*, 31 F.3d 772, 775 (9th Cir. 1994) ("Neither applicable professional standards, nor any legal authority of which we are aware. . . treat deficiencies in internal controls of a company as material to the audit report itself."). Thus, the trial court was correct in concluding, with regard to internal controls, that "plaintiffs cannot rest on their allegations but must come forward with evidence establishing a genuine issue of material fact." 131 F. Supp. 2d at 698.

Finally, appellants make much of an August 22, 1997 memo from Kurt Dinkelacker to the IKON business units, urging them to make best efforts to meet the company's projection of $150 million in operating income for the fourth quarter. "In response" to that "injunction," appellants say (Br. 14), the company "stripped its districts, or operating units, of reserves for doubtful accounts, lease defaults and inventory obsolescence." "The result," according to appellants, "was $54.9 million more [in 1997 income] than IKON actually earned according to GAAP." *Id*. at 15.

That account is both inaccurate and misleading. To begin with, appellants cite *no* support for their claim that IKON "stripped" its reserves after August 22, and none exists. Indeed, IKON substantially *increased* its allowance for doubtful accounts in 1997. J.A. 5298 (workpaper). And there is no evidence that anyone at IKON responded in any fashion to Dinkelacker's purported "injunction." Finally, nothing in the record suggests that E&Y was even *aware* of Mr. Dinkelacker's memo in 1997.

b. Appellants also proffer an array of individual criticisms of the audit – an alleged imbalance in this district, a supposedly unreconciled item in that district, and so on. These criticisms – which are scattered throughout appellants' Statement of Facts and reprised, at least in part, in the Argument section of the brief – are an evident attempt to attack the audit with a thousand cuts. They also seek to convey the impression to this Court that somewhere in this goulash of facts must lurk a material issue in dispute.

One is tempted to respond simply by invoking the governing standard and letting it go at that. After all, none of these individual quibbles, taken alone or together, shows anything close to a "pretended audit." Nevertheless, because appellants have managed to find damages experts who pitch this as a billion dollar case, we are constrained to respond to these individual charges. As we next show, each of these charges, while seemingly discrete, runs afoul of overarching legal principles. We set out those principles – and the allegations that cannot be squared with them – below.

E&Y opined on IKON's consolidated financial statements, not on the financial statements of a single district or on a particular account. Much of appellants' bill of particulars overlooks the fact that E&Y opined on the *consolidated* financial statements of IKON, taken as a whole. As Judge Katz recognized – but as appellants' piecemeal challenge deliberately obscures – IKON did not separately report on, nor did E&Y separately opine on, any of the individual districts or balances on which appellants dwell at such length.

Nowhere do appellants overlook this principle more fundamentally than in their treatment of E&Y's audit of the Southern California marketplace. Appellants allege (Br. 21-23) that E&Y failed to insist that IKON book certain *draft* findings from a compliance audit[18] performed at IKON-Southern California. In particular, appellants allege (Br. 23-24) that during this internal audit E&Y identified approximately $7 million of adjustments negatively impacting earnings.

But IKON-Southern California was a *single marketplace* within a *single district* within IKON. Indeed, IKON-Southern California accounted for only 2.2% of IKON's

[18] A compliance audit is a review, through an internal audit function, of a business unit's compliance with IKON policy.

revenues and 0.7% of IKON's assets. The suggestion that E&Y could be found "reckless" for putative judgment errors (and there weren't any) identified in a single marketplace fundamentally misapprehends the nature of an audit. For example, appellants contend (Br. 21-22, 40-41) that the lease default reserve in the Southern California marketplace was understated by $4.2 million.[19] Even on its own terms, this contention is mistaken – for one thing, the amount of alleged understatement is calculated without taking into account the value of the underlying copier equipment on all defaulted leases.[20]

But more fundamentally, appellants simply ignore the fact that E&Y opined, not on the adequacy of the reserves in Los Angeles, but on the overall consolidated financial statements of IKON, a $5 billion company – and it is entirely to be expected that an under-accrual in reserves in one part of the company may be matched by an

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[19] Appellants also say that E&Y agreed that "the lease default reserve was clearly understated" in Southern California (Br. 22). In fact, E&Y reported only that "IKON *policy* requires that the default reserve should be at least 3%." J.A. 4825 (workpaper).

[20] Appellants take a 6% district "charge-back" rate (leases taken off the books of IKON Capital, the IKON lease financing entity, and "charged back" to the individual district after 120 days of non-payment on a lease); subtract a district reserve of 1.8%; and thereby determine a shortfall of 4.2%, resulting in a $4.2 million under-reserve on a portfolio just shy of $100 million in Southern California. The analysis completely omits any adjustment for "recoveries" – the value of equipment retrieved from the defaulting lessee or the dollars obtained from the lessee through settlement, litigation, or otherwise.

over-accrual elsewhere. There is absolutely no evidence that E&Y acted recklessly in determining the adequacy of the lease default reserve on a consolidated basis. To the contrary, the record shows that E&Y performed extensive procedures to evaluate the appropriateness of the reserve (J.A. 4107, 4114 (Mulherin Dep. 149-51; 177-79); J.A. 3478-3479 (Nepa Dep. 550-53)) and that IKON personnel confirmed the adequacy of the reserve. J.A. 4889 (Slack Dep. 51-52). IKON had a consolidated lease default reserve of 3.38% at September 30, 1997, whereas its gross chargebacks were less than 3% and the chargebacks (net of recoveries) were thus even lower. J.A. 5307-08; J.A. 661-713 (workpapers); J.A. 4889 (Slack Dep. 51-52).[21]

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[21] What is more, the document upon which appellants base their assertions is a *draft* internal audit report, marked clearly "***for discussion purposes only***," and prepared sometime after the internal audit fieldwork was completed in late October 1997 – after the balance sheet date of the IKON consolidated financial statements on which E&Y issued its opinion. J.A. 4820-25 (emphasis in original). Although E&Y reviewed all finalized internal audit reports in connection with its post-audit procedures for IKON's December 24, 1997 10-K filing (J.A. 4827) (workpaper), the evidence in the record clearly indicates that the Southern California internal audit was not completed during fiscal 1997 (J.A. 4828-31) (workpaper), and that the draft internal audit report was not finalized before E&Y's release of its audit opinion on December 24, 1997. J.A. 4823; J.A. 4833 (workpapers); J.A. 3476 (Nepa Dep. 543). Furthermore, during its audit work E&Y sought and obtained representations from IKON's Director of Internal Audit that there were no findings with respect to any of the audits still in process as of the date of E&Y's final audit procedures that would materially affect IKON's September 30, 1997 audited financial statements. J.A. 4827 (workpaper); J.A. 3476-77 (Nepa Dep. 543-45); J.A. 5453 (Mulherin Decl. ¶ 28).

The remainder of appellants' allegations regarding Southern California relate to a supposed $2.8 million in overstated inventory, mostly due to problems with

The same principle holds true for appellants' allegations about E&Y's work in Northern California. Here again, appellants lose sight of the consolidated nature of the audit. And their more particular quibbles don't hold water, either. As appellants note (Br. 38-40), IKON Northern California encountered difficulty using the SAP computer system. These problems made it difficult to audit the collectibility of the accounts receivable in Northern California, and thus to evaluate that district's estimate of the reserve for doubtful accounts. E&Y performed procedures to assess accounts receivable as of June 30, 1997. Because of, among other things, the problems associated with the SAP system, E&Y concluded that it was difficult to make an accurate assessment of the accounts receivable reserve at that interim date. Accordingly, additional procedures were performed after June 30, 1997. J.A. 4158 (Mulherin Dep. 350); J.A. 5451 (Mulherin Dec. ¶ 21); J.A. 4778-82 (workpaper).

First, the head of IKON's Internal Audit department, Daryle Yergler, visited the

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inventory reconciliation. Br. 23. But in the latter connection, E&Y's draft internal audit report does not state that the inventory problems posed a risk of misstatement; it states only that there would be an increasing risk of misstatement if the inventory was not reconciled. J.A. 4821 (workpaper). Accordingly, as the trial court found, the evidence does not show that E&Y knew of a risk of material misstatement at the close of the fiscal year. 131 F. Supp. 2d at 703. See *Stamatio* v. *Hurco Companies, Inc.*, 892 F. Supp. 214, 218 (S.D. Ind. 1995) ("Even accepting as true Plaintiff's allegations that Defendants knew that it had inventory problems. . . , that fact standing alone does not show that Defendants knew that the statements in their prospectus or other representations were materially false and misleading at the time the material statements were made.").

Northern California district and evaluated accounts receivable as of August 31, 1997. J.A. 4783-93 (workpaper). Yergler tested the accuracy both of the recorded accounts receivable and of the corresponding reserve (EY 562482 **(cite to S.J. Exhibit?**). He concluded that the Northern California district required a GAAP reserve of at least $7 million to account properly for doubtful accounts receivable.

E&Y then reviewed and challenged Yergler's work. Although it found Yergler's approach to be adequate, it concluded that there should be a larger reserve for potential bad debts. J.A. 4794-4801; J.A. 887-92 (workpapers). E&Y therefore concluded that the additional reserves recommended by Yergler should be significantly increased, for a total reserve of $8.5 million. Because Northern California maintained only a $3.2 million reserve at the time, E&Y ultimately posted the $5.3 million difference to a Summary of Audit Differences. J.A. 892; 4802 (workpapers). All told, this and other unbudgeted auditing work required E&Y to devote a total of 1,014 hours to the Northern California audit work – a full 414 hours, or approximately 70 percent, more than the budgeted hours for 1997. J.A. 5451 (Mulherin Dec. ¶¶ 22-23); J.A. 3149, 4803-05 (workpapers).

Appellants claim (Br. 76-77) that the district court failed to credit the testimony of their experts, who opined that E&Y was reckless when it "permitt[ed]" Yergler to "set[] the allowance for doubtful accounts." If appellants mean to suggest that E&Y

did not audit this balance, that is simply not true. Although E&Y did, to be sure, review Yergler's work, the evidence unambiguously shows that E&Y challenged and retested the work before reaching its own conclusions. J.A. 4794-801; J.A. 887-892 (workpapers).

In short, E&Y's work in Southern and Northern California does not remotely constitute "recklessness" within the meaning of the case law. But it bears repeating, appellants have seized on a few discrete parts of the 1997 IKON audit – sometimes a single district, sometimes (as in the case of Southern California) just a single marketplace *within* a single district – and lost sight of the fact that these are just a handful of the districts and other entities that E&Y audited in 1997. To the remainder appellants pose no challenge, and surely that's not for want of trying. The fact that appellants' allegations are limited to so few locations is a tell-tale sign that, in fact, they cannot possibly meet their burden of proving that E&Y's work was "so shoddy" as to amount to nothing more than a "pretended audit." *McLean*, 599 F.2d at 1198.

Appellants' challenges are predicated on matters of quintessential auditing judgment. Many of appellants' criticisms (see, *e.g.*, Br. 69-70) founder on a second principle: they constitute highly technical disagreements with highly judgmental auditing decisions, and they are thus the very *weakest* possible issues on which a claim of "recklessness" could be predicated. See, *e.g.*, *Mathews* v. *Centex Telemanagement,* *Inc.*, No. 92-1837 CAL, 1994 WL 269734, at *6 (N.D.Cal. Jun. 8, 1994) (granting summary judgment despite expert's claim that reserves should have been larger). Indeed, even if appellants had the better view of auditing practice (and they do not), the real question before the Court is this: Have appellants adduced a factual record on which a well-instructed jury could find, by a preponderance of the evidence, that on these highly technical, highly judgmental auditing decisions, E&Y intended to mislead or was so exceedingly reckless that its work product constituted a "pretended audit"? *McLean*, 599 F.2d at 1198. Do appellants have *any* evidence – other than the self-serving opinions of their experts (which are not evidence at all) – that E&Y's judgments were so flagrantly wrong "as to lead to the conclusion that there was no genuine belief back of it"? *Ibid*. The answer, quite plainly, is "no." And nowhere is that plainer than in connection with appellants' allegations about the reserve for doubtful accounts.

Appellants attribute fully \$20.689 million of the alleged \$54.9 million overstatement of IKON's 1997 pre-tax income to IKON's supposed under-accrual of its allowance for doubtful accounts. J.A. 5059 (Devor Dep. 179).[22] But as even

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[22] Included in this \$20.689 million is the alleged "known" \$3.6 million shortfall in IDS/IMS reserves. See Br. 24-25, 34. Accordingly, we do not discuss this issue separately. It is worth noting, however, that appellants' assertion that E&Y "knew" that the IDS/IMS reserve was understated misstates the record. Appellants correctly note that E&Y's field auditors alerted the E&Y personnel in Philadelphia to

appellants' experts were constrained to admit, estimating a reserve for doubtful accounts is an extraordinarily judgmental activity by IKON, and auditing that estimate is a highly judgmental activity by E&Y. J.A. 5091 (Devor Dep. 305-06); J.A. 4998 (Carmichael Dep. 344). It requires the auditor to assess the risk that some or all of an existing receivable will never be collected. Except for auditors equipped with crystal balls – or the occasional well-paid expert prepared to feign special insight – such estimates are subject to considerable debate, and reasonable auditors can and do disagree about how much the reserve should be. See, *e.g.*, *Mathews*, 1994 WL 269734, at *6 (reserves are "essentially predictions about the future. The fact that a future prediction turns out to be wrong does not mean it was fraudulent when made");

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the fact that IDS maintained no separate reserve for certain receivables that had been transferred to IDS from IMS. The record, however, contains no support for the claim that IDS was underreserved at year end 1997. Appellants' claim appears to be based upon an unwarranted conflation of IKON policy and GAAP and overlooks a $3 million excess reserve at IDS in 1997 (EY 020506-07) (Ex. 63) **Replace with J.A. cite**. What is more, E&Y's review of the accounts receivable reserve on a consolidated basis demonstrated that the consolidated reserves were adequate, even if (per appellants' assumption) the reserve at IDS *individually* was insufficient. It is, of course, not unexpected that over-accruals at some locations would offset under-accruals at others. And the allegation that E&Y Philadelphia did no work to evaluate accounts receivable on a consolidated basis (Br. 24) is demonstrably false. Attached to E&Y's summary judgment papers were documents showing this very work. J.A. 5290-5306. See also EY 035337-43 **(Replace J.A. cite)**; J.A. 4164, 4167, 4195, 4197 (Mulherin Dep. 375-77, 385-88; 492-94, 500-01); J.A. 3474-3475 (Nepa Dep. 532-37).

Price Waterhouse, 797 F. Supp. at 1229 (noting that such "reasonable disagreements cannot support an inference of recklessness or fraud").

Thus, even if (contrary to fact) the record in this case called into question E&Y's analysis of the 1997 IKON reserve for doubtful accounts, this Court should be most reluctant to permit a jury to speculate whether, on such a highly judgmental matter, IKON's judgment about what reserves to book, and E&Y's audit assessment of it, were so extraordinarily flawed that E&Y's work amounted to a "pretended audit." *McLean*, 599 F.2d at 1198. But in fact, the record does not, in the slightest, call E&Y's judgment into question. Indeed, appellants' contrary view rests on little more than the fact that the reserve was less than what IKON's *internal policy* required: The $20.689 million supposed understatement is simply the amount by which IKON was out of compliance with *IKON policy* (adjusted for unapplied cash and credits) as of September 30, 1997. J.A. 2664 (Devor/Carmichael Rpt. ¶ 24); J.A. 722-771 (workpaper). True, appellants now tell us that their experts "confirmed" this figure for the alleged understatement of the reserve with "three separate, independent methodologies having nothing to do with IKON policy" (Br. 28); but the fact is, the number was taken directly from a schedule prepared by E&Y during the

Special Procedures to display the amount of reserves that would have been called for under a mechanical application of the IKON policy formula. J.A. 722-771.[23]

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[23] As for the "three different GAAP methodologies" (Br. 33), none of these makes the slightest sense. The first "methodology" compares the $20.689 million policy number to the $19.9 million adjustment to accounts receivable reserves that IKON ultimately booked in the third quarter of 1998 as a result of the Special Procedures. See **EY 130165**. Presumably because $20.689 million is close to $19.9 million, appellants surmise that there was an under-reserve of $20.689 million at year-end 1997. In fact, this is a total non-sequitur. The $19.9 million adjustment booked in the third quarter was the result of operational decisions that IKON made in 1998. See **Forese Dep. (describing decision in 7/98 not to chase Ncal and SW A/R); cite 7/98 Dinkelacker memo to Forese; cite testimony, perhaps from Dillon, on deterioration of A/R in FY 1998**. It had absolutely nothing to do with the whether reserves were adequate in 1997, and no one but appellants' experts has suggested otherwise. The same defect impairs appellants' second "methodology," in which they propose to take the percentage of accounts receivable reserve to the total receivables balance at June 30, 1998, apply that percentage to the receivables balance at September 30, 1997, and measure the spread between the actual reserve and the hypothetical reserve obtained in this manner. Because the resulting figure (about $22 million) is a lot like $22.689 million (*mirabile dictu*), appellants find confirmation for their experts' selection of the number dictated by IKON policy. But the reserve percentage at June 30, 1998 was derived by adding the $19.9 million following the Special Procedures. And that $19.9 million, as noted, was added at June 30, 1998 because of operational decisions made in fiscal 1998. There is no reason (other than the desire to reverse engineer the IKON policy figure of $20.689 million) to apply the resulting percentage at June 30, 1998 to the receivables balance at September 30, 1997. The third "methodology" is worse yet: it takes an alleged under-reserve in the Southern District (which was based on an interim *policy* assessment by E&Y auditors, which was later revised at September 30, 1997, after additional GAAP procedures **(cite McElderry)**); an alleged under-reserve at IDS (which, as we explain elsewhere (**supra __)**, is entirely fictitious); and the amount posted by E&Y on the Summary of Audit Differences as the *actual* under-reserve for Northern California (**cite)**, adds the three figures, comes up with the figure $12.1 million, and then concludes that $20.689 must be about right if there is an under-reserve of $12 million "for just these three districts." Br. 34.

But IKON prepared its consolidated financial statements in accordance with GAAP, which it did not equate with its internal policy. And virtually every witness in the case – every E&Y witness, virtually every IKON witness, Arthur Andersen (J.A. 3168, 3178) (McAleer Dep. 74, 113-114), and E&Y's accounting expert (Lynford Graham, from the national accounting firm of BDO Seidman, LLP) – agreed that a departure from IKON policy does not amount to a failure to comply with GAAP. The trial court was therefore entirely correct in concluding that appellants' experts' contrary opinion was devoid of "any facts to support the idea that substantively, a deviation from IKON's policy necessarily was a deviation from GAAP." 131 F. Supp.2d at 701.

Why would a company's internal accounting policies possibly deviate from what GAAP requires? As the record in this case illustrates, companies like IKON often establish inflexible accounting policies, to be applied to all of the company's business units in a uniform manner – policies that do not call for the exercise of judgment at each business unit and location. It is not uncommon to encounter

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There simply is no escaping the matter: appellants' experts selected $20.689 million as the putative under-reserve for accounts receivable because that was the figure used by E&Y during the Special Procedures to indicate the shortfall *from IKON policy*. It is not surprising that, in light of the evidence and the law, appellants wish to retreat from this position. But it is too late in the day to do so.

policies, for example, that call for the mechanical application of a formula. IKON's internal policies were just such policies.

In the case of accounts receivables, IKON policy in 1997 required IKON's districts to reserve 33⅓ percent of the amount of receivables outstanding, or aged, 91-150 days, 66⅔ percent of the amount aged 151 to 180 days, and 100 percent of the amount aged greater than 180 days. J.A. 4781 (workpaper). This was a set "floor" on the reserves at each district, and to the extent that such a floor was not actually needed (for example, because even the older debts were in fact collectible), the policy reserves necessarily differed from the GAAP reserves used in IKON's consolidated financial statements. By promulgating mechanical rules such as these, IKON management furthered several objectives: it encouraged IKON district management to be aggressive in collecting receivables and selling inventory (by requiring steep reserves if management failed to do so); it ensured that all uncollectible amounts would be fully reserved; and it promoted uniformity across the many disparate IKON entities. J.A. 3104 (Stuart Dep. 60-62); J.A. 33889A (Dinkelacker Dep. 44); J.A. 5453-54 (Mulherin Dec. ¶¶ 30-31).

By contrast, GAAP has the purpose of providing a common framework for making judgments about accounting estimates that will result in reasonably comparable financial statements from year to year across a spectrum of companies.

Such estimates require the use of judgment and the evaluation of numerous factors in order to calculate an amount that adequately reserves for receivables that will not be paid. J.A. 5453-54 (Mulherin Decl. ¶ 31); J.A. 3474 (Nepa Dep. 532-37). It does *not* require application of a single, mechanical formula. See *Lovelace* v. *Software Spectrum, Inc.*, 78 F.3d 1015, 1021 (5th Cir. 1996) ("an ethical, reasonably diligent accountant may choose to apply any of a variety of acceptable accounting procedures") (internal citations omitted). Not surprisingly, therefore, witness after witness, from both E&Y and IKON, testified that a departure from IKON policy is *not* a failure to comply with GAAP.[24] Instead, nearly to a person, they recognized that

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[24] J.A. 3389A (Dinkelacker Dep. 44); J.A. 3538 (Dillon Dep. 117-118); J.A. 3104 (Stuart Dep. 60); J.A. 3658 (Royce Dep. 387-88); J.A. 3724 (Yergler Dep. 154-155); J.A. 3006 (Shoemaker Dep. 110); J.A. 3811 (Sheehan Dep. 231-232); J.A. 3834 (Koppy Dep. 49-50); J.A. 3914 (DeBoer Dep. 186-187); J.A. 3956 (Koether Dep. 127); J.A. 3977 (Deverall Dep. 115-116); J.A. 4032 (Hooper Dep. 111-112); J.A. 4096 (Mulherin Dep. 103); Nepa Dep. 811; J.A. 3073 (Berry Dep. 159); J.A. 4291 (Lilholt Dep. 148); J.A. 4359 (Cain Dep. 206); J.A. 4372 (Burnett Dep. 43); J.A. 4443 (Yanis Dep. 198); J.A. 4464 (McElderry Dep. 73); J.A. 4515 (Dougherty Dep. 138-139); J.A. 4548 (Peluso Dep. 66); J.A. 4606 (Spencer Dep. 39-40); J.A. 1035 (Chekian Dep. 76); J.A. 4659 (Chan Dep. 86). Even Mr. Royce, on whom appellants rely for the proposition that IKON policy is the equivalent of GAAP (Br. 32), actually testified repeatedly that IKON policy is different from GAAP. J.A. 3571, 3658-59, 3667 (Royce Dep. , 393-94, 423). Indeed, Royce wrote a memo that distinguished IKON policy from GAAP in considerable detail. J.A. 4695-97. Appellants' reliance (Br. 36) on the Accounting Policy Manual section relating to accounts receivable is similarly misplaced. Although one purpose of the policy may be to ensure that reserves are adequate under GAAP, this hardly means that IKON policy – which consists, by and large, of a series of mathematical calculations – is the same as GAAP. Peter Shoemaker, whose May 7, 1998 memo detailing a shortfall

IKON policy could yield reserve amounts that differed from (and generally were much more conservative than) those appropriate under GAAP.

Accordingly, evidence that various districts did not comply with IKON policy is not evidence that IKON's consolidated financial statements did not comply with GAAP.[25] But it bears repeating that the standard is *not* whether appellants on the one

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from policy of some $59 million appellants repeatedly cite (Br. 11, 15), made that very point. In a portion of his memo that appellants omit to mention (see J.A. 5312), he states that "this may not be an issue of compliance to GAAP, but only to company policy." In any event, whether or not there is an issue of material fact with regard to the difference between IKON policy and GAAP, the uniform belief held by both IKON and E&Y personnel that IKON policy is different from GAAP – a belief effectively concurred in by Arthur Andersen – negates any inference that "no reasonable auditor" could believe that GAAP may differ from IKON policy.

[25] Appellants cite evidence from which one may infer that IKON policy was perhaps *designed*, when it was first adopted, to achieve a number that is acceptable under GAAP. See J.A. 4923 (Carmichael Dep. 41-44), J.A. 5061-63 (Devor Dep. 185-196); 131 F. Supp. 2d at 700-01. But GAAP does not require auditors to use a single, standardized procedure to evaluate reserves. See *Thor Power Tool Co.* v. *Comm'r*, 439 U.S. 522, 544 (1979) ("Accountants long have recognized that 'generally accepted accounting principles' are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions."). Accordingly, while IKON policy may yield a reserve that is acceptable under GAAP, IKON policy does not yield the *only* number that is acceptable under GAAP. Indeed, even appellants' experts admitted that GAAP does not require the use of mathematical formulas such as those provided for in IKON policy. J.A. 4917 (Carmichael Dep. 17-20); J.A. 5066-68 (Devor Dep. 205-206). Accordingly, E&Y's decision not to insist that IKON use only the numbers generated by IKON policy cannot be "highly unreasonable conduct, involving . . . an extreme departure from the standards of ordinary care." *McLean*, 599 F.2d at 1997. See *Mathews* v. *Centex Telemanagement, Inc.*, No. C-92-1837-CAL, 1994 WL 269734, *5 (N.D. Cal. 1994) (granting summary judgment even where plaintiffs' expert testified that the company should have used

hand, or IKON, E&Y and Arthur Andersen on the other, ultimately have the better view of IKON's reserve estimates. Instead, for appellants to survive summary judgment, this Court must be persuaded that the evidence is so utterly one-sided that a reasonable jury could fairly conclude that E&Y could not have believed that the reserve for doubtful accounts in IKON's consolidated financial statements complied with GAAP. On this record, no one can seriously make that claim. And as the trial court correctly concluded, a jury should not be permitted to consider it.

A non-movant may not create a disputed issue of fact simply by selective or incomplete citation of the record. This principle seems basic enough, and yet time and again appellants lose sight of it. Their treatment of the intercompany accounts at IDS and IMS illustrates the point.

Appellants observe (Br. 26) that as a result of the Special Procedures E&Y determined that there were approximately $7 million in intercompany acccount errors as of September 30, 1997, some $4 million of which related to IDS and IMS. True enough. But appellants go on to say that the $4 million was "the very same imbalance about which E&Y-Houston had issued its [warning] during the 1997 audit." Br. 26. Appellants provide no citation for this claim, and it is in fact untrue. Nor is it true that

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a higher reserve for accounts receivable).

E&Y's "management letter for the IDS unit" shows that, notwithstanding the testimony of the auditors, the intercompany accounts *did not* eliminate at September 30, 1997. Br. 26 (citing J.A. 2672). Significantly, appellants' citation is to their experts' report, not to the management letter. The management letter itself, by contrast, did *not* say that the accounts were unreconciled at *year end*; it said, instead, that E&Y had observed unreconciled intercompany accounts in the course of considering IKON's internal controls, and that the company might wish to improve those controls by reconciling intercompany accounts on a monthly basis (rather than having to adjust at year end). J.A. 928-929.[26]

More generally, appellants err when they insist that the identification of errors during the course of the Special Procedures in 1998 proves that E&Y acted recklessly when it conducted the 1997 audit. That argument runs afoul of one final principle: *The discovery of errors after the conclusion of an audit does not, without more, demonstrate a negligent, much less reckless, audit*. That principle is especially applicable in this case. The Special Procedures, after all, were a "detailed and

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[26] Moreover, appellants' suggestion that E&Y did not "review eliminations" of intercompany balances finds no support in the record. Workpapers reflecting E&Y's audit procedures on intercompany balances can be found at J.A. 5262-5289. And Carmen Nepa testified that "we reviewed the company's reconciliation and tested it to our satisfaction and concluded that it was reasonable." J.A. 3489 (Nepa Dep. 593).

comprehensive examination" that involved "an in-depth look at IKON's account balances over $100,000." J.A. 4712 (Graham Rpt.). In contrast, the 1997 year-end audit was performed only at selected locations and employed a "tolerable error" threshold of $1.7 million. J.A. 4726 (Graham Rpt.). Accordingly, the year-end audit "could not provide assurance that every single discrepancy in every single account would be identified." *Ibid*. Indeed, as the professional standards recognize, "an audit conducted in accordance with [GAAS] may not detect [even] a material misstatement." AU § 230.10. That is so because "the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance," and thus "the auditor is not an insurer and his or her report does not constitute a guarantee." AU § 230.13.

It follows that the discovery during the Special Procedures of unreconciled intercompany accounts or other reconciliation errors does *not*, by any stretch, suggest the presence of fraud. The courts call such logic "fraud-by-hindsight" (see *Shields* v. *Citytrust Bancorp., Inc.*, 25 F.3d 1124, 1129 (2d Cir. 1999)), and have uniformly refused to accept it.[27]

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[27] Appellants further allege that IKON's 1997 pretax income was overstated by $6,173,000 because IKON did not record certain adjustments proposed by E&Y in 1996 and 1997, together with various other adjustments conjured up by appellants' experts. J.A. 2672-74 (Devor/Carmichael Rpt. ¶¶ 42-44). Appellants' experts apparently admit that adjustments proposed by E&Y need to be posted to the balance

4. The district court correctly concluded that E&Y's performance of the 1998 Special Procedures did not give rise to an inference that the 1997 audit was reckless

In their Statement of Facts (although not in their Argument section), appellants contend (Br. 44) that E&Y's performance of the Special Procedures supports an inference of recklessness. They focus on two aspects of the work: E&Y's response to certain allegations of wrongful conduct by IKON management; and IKON's decision, accepted by E&Y, to allocate the $110 million in charges to the second and third quarters of 1998. The trial court correctly concluded that neither allegation has any merit. One point should, however, be made at the outset: Even were there merit to these claims, an alleged "cover up" during the *1998* Special Procedures is not probative of E&Y's state of mind at the time of the *1997* year-end audit. See, *e.g.*, *Weber* v. *Contempo Colours, Inc.*, 105 F. Supp. 2d 769, 773 (W.D. Mich. 2000) (plaintiff had not alleged scienter where complaint did not support the conclusion that the defendant knew the challenged statement was false at the time he made it); *Reiger*

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sheet only when they become material, and state only that these adjustments "are material when the other components of the $54,962,000 are considered." *Id.* ¶ 44. In other words, even in appellants' experts' view, the failure to post these adjustments results in a misstatement only if appellants are correct (i) about the remaining components of the alleged $54.9 million overstatement and (ii) that E&Y recklessly failed to reach the same conclusion in 1997. As we have explained, appellants are not correct with regard to either proposition (let alone *both* propositions), and accordingly are wrong as well with regard to the adjustments proposed by E&Y.

v. *Altris Software*, No. 98-CV-528, 1999 WL 540893, *9 (S.D. Cal. Apr. 30, 1999) ("[A] statement's falsity, even if profound, does not raise an inference of scienter on the part of an auditor absent circumstances indicating that the auditor must have been aware of the falsity at the time the statements were made."). At issue here is E&Y's state of mind in 1997, and appellants cannot resuscitate their case by referring to E&Y's state of mind months after it issued the audit opinion at issue. See Fed. R. Evid. 404(a) ("Evidence of a person's character or trait of character is not admissible for the purpose of proving action in conformity therewith on a particular occasion . . . .") In any event, as we next show, appellants' allegations about the Special Procedures are baseless.

a. In July of 1998, in the course of conducting the Special Procedures, George Berry received several memoranda from Michael Dudek, an IKON official, regarding complaints about accounting issues that had been leveled by several IKON employees against IKON management.[28] Berry made sure that top IKON management and

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[28] Appellants have proffered no evidence showing that any of these complaints related to accounting practices in 1997 affecting the preparation of the 1997 financial statements, as opposed to issues arising in 1998, when the complaints were made (Yergler Dep. 460-61) and the memos were written. And although appellants repeatedly refer (Br. 42-43, 46) to one especially colorful complaint – mentioning "unnatural acts" – they neglect to inform the Court that the person who likely made this remark explained that it was taken "totally out of context" and that the "unnatural act" he had in mind was requiring his staff to "work any more than they're already working." J.A. 3650 (Royce Dep. 358).

IKON's Board knew of the allegations; he encouraged IKON to hire independent counsel to investigate; and he delivered the Dudek memoranda to the independent counsel. E&Y also included steps within the Special Procedures program designed to ensure that E&Y field auditors reviewed the issues raised by the memoranda. 131 F. Supp. 2d at 695-96; J.A. 354-55 (Nepa Dep. 23-28). Nonetheless, appellants' experts believe that E&Y should have responded differently, citing AU § 561 ("Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"). Br. 41-46, 77-78. But as the trial court correctly explained, the plain language of AU 561 requires that an investigation be performed only if the information is deemed reliable[29] and would have changed the report previously made. J.A. 1137-39 (AU § 561). Furthermore, as the trial court also noted, one of appellants' own experts admitted that "the precise means of investigation are left to an auditor's judgment." 131 F. Supp. 2d at 696 (citing J.A. 5135 (Devor Dep. 480-81)).

True, appellants' experts tell us that they would have done things differently had they been in charge of the Special Procedures. The same claim was made to the Ninth Circuit in *Worlds of Wonder* with this result: "[Plaintiffs' expert's] declaration consists of self-righteous statements that, because Deloitte did not audit WOW as he

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[29] Appellants paraphrase AU 561 in their brief (at 42), but omit the "reliability" criterion.

would have done, Deloitte must have acted fraudulently. Such evidence is not sufficient." 35 F.3d at 1426-27.

b. As for the suggestion that it was "a cover-up" to allocate the adjustments to the second and third quarters of 1998 (Br. 44), that charge cannot be squared either with the record or with Andersen's involvement in the Special Procedures. Appellants argue, for example, that E&Y "invented" "phony" adjustments to IKON's inventory and accounts receivable reserves, and did so by "changing" the recommendations of E&Y auditors working at various IKON field locations. Br. 48-51. Appellants seem to assume that the numbers submitted by the "field" would never be challenged, examined, or modified – an assumption belied by all of the evidence.[30] Every E&Y and IKON witness involved in the Special Procedures explained to the appellants during deposition that the work done by the field auditors was always intended to be reviewed at the corporate level to see if the results made sense in the overall,

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[30] Appellants compound this error by misunderstanding even what E&Y's auditors did during the Special Procedures. Thus, for example, they fault E&Y's senior manager on the IKON audit, Carmen Nepa, "for using $8,500,000" as the reserve for doubtful accounts in Northern California, whereas Irv Dennis, an E&Y partner, had ostensibly "recommend[ed]" $13,700,000 as the "required reserve." Br. 48. But as George Berry explained (J.A. 500 (Berry Dep. 129-131)), and as the relevant workpapers confirm (J.A. 1189), Mr. Dennis's proposed $13,700,000 reserve comprised not only the reserve for doubtful accounts, but also the reserve for IOS Capital receivables and intercompany receivables. The portion that covered trade accounts receivables was only $8 million – or, in other words, *less* than the amount that Mr. Nepa ultimately recommended. *Ibid*.

consolidated context.[31] Arthur Andersen understood this as well; the two principal Andersen partners who worked on the Special Procedures explained during deposition that decisions about the inventory reserve had been made at the corporate level, and that there was a "very good possibility" that the numbers were different from the final submissions from the field. J.A. 3237 (Costello Dep. 129-130; see also J.A. 3168 (McAleer Dep. 75). It defies credibility to suggest, as plaintiffs do, that Andersen, which was hired to represent interests other than E&Y's, would countenance the invention of a "phony" adjustment for reserves.

Indeed, as the trial court noted (131 F. Supp. 2d at 699), if (as appellants maintain) these adjustments were nothing more than an attempt to conceal errors in IKON's 1997 financial statements, then Andersen – which was watching over E&Y's shoulder throughout the Special Procedures – must have been in on the "cover-up." Not even appellants can bring themselves to make that claim. As the trial court concluded, in the absence of "evidence as to how the allegedly blatant cover-up escaped the notice of the investigators, or evidence suggesting that Andersen was

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[31] For example, Alan Lilholt, whose work during the Special Procedures appellants cite at length (Br. 50-51), made crystal clear that his proposed reserve figure of $3,445,000 was a "first-pass guess" based on merely "a day-and-a-half of experience at IKON." Its purpose, he explained, was to provide input to "E&Y corporate, who might have more information, or the overall perspective of the experience with the company that could cause these numbers to change." J.A. 4292 (Lilholt Dep. 150-151).

somehow involved in the cover-up . . . Ernst's conduct during the Special Procedures was not such an extreme departure from the standards of ordinary care that it would constitute notice of scienter." 131 F. Supp. 2d at 699.

III. THE DISTRICT COURT CORRECTLY HELD THAT E&Y CANNOT BE HELD LIABLE FOR STATEMENTS MADE IN IKON'S PRESS RELEASE DATED OCTOBER 15, 1997

Granting partial summary judgment, in the alternative, the trial court dismissed all of appellants' claims "as to the period from October 15, 1997 to December 24, 1997." 131 F. Supp. 2d at 685. Those claims, the trial court noted, were predicated upon an "October 15, 1997 press release" issued by IKON — not by E&Y — which "did not mention the defendant accounting firm, nor did it refer to an audit." *Id*. at 685 n.5; see J.A. 5150-5155 (press release). Rule 10b-5, however, requires a plaintiff to prove that *the defendant* made a "misstatement or omission of material fact." *Semerenko*, 223 F.3d at 174. The only statement made *by E&Y* in connection with IKON's performance in 1997 was its audit opinion on the 1997 financial statements – an opinion that was not released until December 24, 1997. Thus, the trial court reasoned, claims based on the October 15, 1997 press release by IKON could not "form a basis for a Section 10(b) claim" against E&Y. 131 F. Supp. 2d at 685. A contrary conclusion would be inconsistent with *Central Bank of Denver* v. *First Interstate Bank of Denver*, 511 U.S. 164 (1994), which abolished aiding-and-abetting liability under Rule 10b-5. The trial court also rejected appellants' alternative contention that E&Y could still be held liable after *Central Bank* because it "substantially participated" in the issuance of the October 15 press release. These rulings were correct and should be affirmed.

A. *Central Bank* Bars Appellants' Claims Based On The IKON Press Release Because That Release Contained No Statements Attributed To E&Y

In *Central Bank*, the Supreme Court held that a cause of action based on aiding and abetting defies the plain language of Section 10(b), which "prohibits only the *making* of a material misstatement (or omission)." 511 U.S. at 177 (emphasis added). Moreover, the Court held, the imposition of "secondary liability" would vitiate the reliance element of the statute, since it would allow for liability "without any showing that the plaintiff relied upon the aider and abettor's statements or actions." *Id*. at 180. As numerous courts have since recognized, *Central Bank* forecloses claims against auditors (like the one appellants sought to bring here) based on their review of audit clients' press releases and clients' disclosure of the results of their operations without reference to and prior to the release of an audit opinion.

In *Wright* v. *Ernst & Young LLP*, 152 F.3d 169 (1998), *cert. denied*, 525 U.S. 1104 (1999), the Second Circuit affirmed the dismissal of a 10b-5 claim against E&Y that is conceptually indistinguishable from the claims at issue here. In *Wright*, the appellants sought to hold E&Y liable on the theory that its audit client had issued a misleading press release "based on Ernst & Young's oral assurances." *Id*. at 172. The Second Circuit held that, under *Central Bank,* a misrepresentation is not actionable against a specific actor unless it is "attributed to that specific actor at the time of public dissemination." 152 F.3d at 175. As the Court of Appeals explained:

> If *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).

Ibid.

The two district courts in the Third Circuit that have addressed this issue have applied the same analysis. In *Vosgerichian* v. *Commodore Int'l*, 862 F. Supp. 1371 (E.D. Pa. 1994) – cited with approval by the Second Circuit in *Wright* – the court held that *Central Bank* precluded a 10b-5 claim against Arthur Andersen based on allegations that the auditor had "advised or concurred with," rendered "guidance and express approval to," and "provided direct and substantial assistance to" the corporate defendant's fraud. *Id*. at 1378. Noting that "[e]ach and every misrepresentation alleged was made by [the corporation]," the court held that the claims were merely "allegations that AA assisted [the corporation] in perpetrating securities fraud and are thus not cognizable." *Ibid*. Accord *Copland* v. *Grumet*, 88 F. Supp. 2d 326, 332

(D.N.J. 1999) (adopting *Wright* and dismissing 10b-5 claim because the auditor's alleged "participation in [the fraud] cannot be considered the equivalent of making the false statements themselves"); see also *In re Kendall Square Research Corp. Sec. Litig.,* 868 F. Supp. 26, 28 (D. Mass. 1994) ("allegations that Price Waterhouse reviewed and approved the quarterly financial statements and the Prospectuses do not constitute the making of a material misstatement") (citing *Vosgerichian*); *Mishkin* v. *Ageloff*, No. 97-CIV-2690, 1998 WL 651065 (S.D.N.Y. Sep. 23, 1998) (same). As in all of these cases, E&Y cannot be liable for statements included in IKON's October 15 press release – at no point does the press release mention E&Y, let alone attribute any statement or representation to E&Y.

In an effort to avoid the holding of *Central Bank*, and to distinguish away the Second Circuit's decision in *Wright*, appellants advance a variety of meritless arguments. First, they note (Br. 89-90) that even after *Central Bank*'s abolition of secondary or aiding-and-abetting liability, an accounting firm can still be held *primarily* liable under 10b-5 if it "violates its own duty." That is true but irrelevant, because primary liability still requires "the *making* of a material misstatement (or omission)" by an accounting firm, which simply did not occur here. *Central Bank*, 511 U.S. at 177 (emphasis added). The only statement or omission made in the October 15 press release was one by IKON rather than by E&Y. Indeed, as the trial court found, the IKON press release "did not mention" E&Y, "nor did it refer to an audit" by E&Y. 131 F. Supp. 2d at 685 n.5. The IKON press release thus cannot be the basis for primary liability on the part of E&Y.

Next, appellants contend that *Central Bank* "recognized that section 10(b) mandates a distinction between *indirect* participation in and aiding and abetting a violation." Br. 90 n.30 (emphasis in original). As support for that assertion, appellants point to the Court's supposed endorsement, in *Central Bank*, of the following proposition of law: "[a]n actor is liable for harm resulting to a third person from the tortious conduct of another 'if he . . . knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other.'" *Central Bank*, 511 U.S. at 181 (quoted in Br. 90 n.30). The quoted language, however, was nothing more than the Court's description of the aiding and abetting concept endorsed by the RESTATEMENT (SECOND) OF TORTS, a doctrine that the Court went on to say was "at best uncertain in application." 511 U.S. at 181. More to the point, in *Central Bank* the Court *rejected* the argument that Section 10(b) should be read to incorporate the RESTATEMENT's aiding and abetting concept.

Finally, appellants attempt to distinguish *Wright* on the ground that the press release in that case affirmatively stated that no audit had been conducted, whereas the press release here was merely silent on that subject. Br. 97 n.35. According to appellants, this Court should seize upon this minor factual discrepancy as a "principled distinction between this case and *Wright*." *Ibid*. Appellants are again mistaken. For purposes of determining whether an auditor has *itself* made a material misstatement (or omission) in a press release issued by some third party, there is simply no difference between a press release that says it contains unaudited results and a press release that fails to mention the auditor. In both cases, any misstatements or omissions are those of *the third party*, not the auditor. Not surprisingly, the court's holding in *Wright* rested on this very point: because E&Y was not mentioned in the company's press release, "E&Y neither directly nor indirectly communicated misrepresentations to investors." 152 F.3d at 175. As the Second Circuit correctly explained, a defendant may not be held liable under Section 10(b) for a particular misstatement unless the statement at issue was "attributed to that specific actor at the time of public dissemination." *Ibid*. "Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b)." *Ibid*. That principle is dispositive in this case.[32]

B. The Trial Court Correctly Rejected Appellants' Argument That Liability Could Be Premised On E&Y's "Substantial Participation" in the Misstatements Made in IKON's Press Release

Unable to prevail under *Wright*, appellants urge this Court to reject the Second Circuit's "bright line rule" in favor of a "significant" or "substantial" participation test under which "secondary actors who participate in the creation of a misrepresentation . . . to such a degree that they may fairly be deemed authors or co-authors . . . are liable as primary violators, assuming all other requirements for Section 10(b) liability have been established." Br. 91 (internal quotations omitted). Relying principally on the panel decision in *Klein* v. *Boyd*, Nos. 97-1143, 97-1261, slip op. (3d Cir. Feb. 12, 1998) (J.A. 5355-5407), which was subsequently vacated by the full court (see J.A. 5408-09), appellants maintain that "the Third Circuit has embraced a 'significant

[32] Appellants erroneously claim (Br. 97 n.35) that in *Wright* there was "no basis . . . to claim that E&Y had endorsed the accuracy of the results." In fact, the *Wright* appellants claimed that the company issued its press release "based on Ernst & Young's oral assurances." 152 F.3d at 172. Appellants also assert that "the factual record" in this case "indicates that the market knew that the results in the Release were audited" (Br. 93); but appellants never say precisely where in "the factual record" this understanding is reflected, and with good reason – there is no such evidence, and it is in fact untrue (since the audit had not yet been completed and no opinion had been issued at the time of the press release).

participation' test." *Id*. at 90-91 & n.31. For at least three independent reasons, the trial court was correct to reject these arguments.

First, a vacated opinion is null and void; it has no precedential value. See *O'Connor* v. *Donaldson*, 422 U.S. 563, 578 n.12 (1975) (decision "vacating the judgment of the Court of Appeals deprives that court's opinion of precedential effect"); *Hanover Potato Products, Inc.* v. *Shalala*, 989 F.2d 123, 130 (3d Cir. 1993) ("vacated panel opinions have no precedential value"). Thus, appellants are wrong to suggest that the panel opinion in *Klein* is entitled to any weight, much less that it somehow represents the law of this Circuit. In granting rehearing en banc, "a majority of the circuit judges of the [Third] Circuit who are in regular active service" (28 U.S.C. § 46(c)) evidently concluded that the panel's opinion was sufficiently doubtful that it should *not* be allowed to stand as a statement of circuit law. And it did so, presumably, on the strength of a suggestion for rehearing en banc that argued that the panel's decision was inconsistent with *Central Bank*. See Exh. A to 1/4/01 Post-Argument Letter. Thus, the only post-*Central Bank* authority on point in this Circuit are the two district court decisions cited above, both of which employed the same analysis as the Second Circuit in *Wright*. See *Copland*, 88 F. Supp. 2d at 332 (adopting *Wright* and dismissing claim against auditor because "participation in [the fraud] cannot be considered the equivalent of making the false statements themselves"); *Vosgerichian*, 862 F. Supp. at 1378 (dismissing claim against auditing firm where plaintiff alleged that the auditor had "provided direct and substantial assistance to" the corporate defendant's fraud).

Second, the *Wright* standard is quite plainly correct. Were the law otherwise, aiding-and-abetting liability would effectively be revived, albeit in a different guise. After all, most if not all public companies ask their auditors to "review" earnings releases, "comment on" them, and provide their "approval" before they issue the releases to the public – often before an audit opinion is issued. If an auditor's performance of those routine functions were enough to convert the press release into the auditor's "statement," *Central Bank* would have no meaning at all. That is the crucial point recognized by the Second Circuit and by the only two district courts in this Circuit to have decided the issue. There is no reason for this Court to break ranks.

Nor is there any reason for this Court to cast its lot with the handful of district court decisions cited by appellants (Br. 91-92) that have suggested that Section 10(b) liability may be extended to persons that have "significant" or "substantial" participation in making the misstatement. As the Second Circuit correctly noted, "[a]llegations of 'assisting,' '*participating in*,' 'complicity in' and similar synonyms . . . all fall within the prohibitive bar of *Central Bank*." *Shapiro*, 123 F.3d at 720 (emphasis added). For that reason, the "substantial participation" standard has been soundly rejected by just about every court to consider it. See, *e.g.*, *Anixter* v. *Home-Stake Production Co.*, 77 F.3d 1215, 1226 (10^{th} Cir. 1996) (declining to adopt substantial participation test; stating, "[r]eading the language of § 10(b) and 10b-5 through the lens of *Central Bank of Denver*, we conclude that in order for defendants to 'use or employ' a 'deception' actionable under the antifraud law, they must themselves make a false or misleading statement."); *Wright*, 152 F.3d at 176 (same). In fact, even the vacated panel decision in *Klein* v. *Boyd*, on which appellants predicate their argument, rejected the "substantial assistance" test as "inconsistent with" *Central Bank*. J.A. 5380-81; see also J.A. 5382 ("[W]e do not consider substantial assistance to be sufficient to establish primary liability under section 10(b) and Rule 10b-5.").[33]

Third, E&Y's role with regard to IKON's press release does not constitute "substantial participation" within the meaning of the cases that have articulated that

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[33] The *Klein* panel would have required a level of assistance that is "sufficiently significant that the statement can properly be attributed to the person as its author or co-author." J.A. 5380-81. As explained below, there is nothing approaching that in this case. Moreover, appellants are wrong to suggest (Br. 91 n.31) that the SEC has endorsed the approach taken in the vacated panel opinion in *Klein*. In fact, the SEC's brief's criticized the panel's approach as "susceptible to misinterpretation" (J.A. 5427). Nor is it right to say that the SEC's arguments were "ultimately adopted" by this Court in *Klein*. Br. 91 n.31. The SEC's *amicus* brief was filed *after* rehearing en banc was granted, and the case subsequently was settled by the parties.

test. For example, in *In re Software Toolworks, Inc.*, 50 F.3d at 628-29, the accounting firm was mentioned by name in a letter to the SEC containing the alleged misrepresentations. Here, on the other hand, E&Y was not mentioned in IKON's press release. In *Cashman* v. *Coopers & Lybrand*, 877 F. Supp. 425, 433 (N.D. Ill. 1995), the appellants alleged that the auditors had "masterminded" the public statements. Here, there is no such allegation. And in *Carley Capital Group* v. *Deloitte & Touche, LLP*, 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998), the auditor had "specifically directed" the company's action, which was considered tantamount to the auditor's own "creation" of the misstatement.

Here, in contrast, appellants' argument is that IKON "consulted E&Y about the release, . . . E&Y reviewed the release, and . . . IKON would not have issued the release without E&Y's approval." Br. 93. There is *no* evidence in this case that E&Y wrote the press release, disseminated the press release, specifically directed its issuance, or was otherwise comparably involved in its creation. To the contrary, IKON's Director of Financial Reporting testified that the decisions on the language of the press release were made by IKON, not E&Y. See J.A. 5238 (Guinan Dep. 205). The "approval" by E&Y personnel of the press release – which, in this setting, means no more than a failure to disagree – plainly fails to satisfy the "substantial assistance" test as applied in the case law.

CONCLUSION

The judgment of the district court should be affirmed.

Respectfully submitted,

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CERTIFICATE OF BAR MEMBERSHIP AND COMPLIANCE WITH TYPEFACE AND LENGTH LIMITATIONS

I hereby certify that I am a member in good standing of the bar of this Court. I further certify that the foregoing Brief of Defendant-Appellee Ernst & Young LLP was prepared using a fourteen-point, proportionally spaced, serif typeface, and that it contains ______ words exclusive of the table of contents, table of authorities, Statement of Related Cases, and certificates of counsel.

____

Edward M. Posner

IN THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

IN RE: IKON OFFICE	)	
SOLUTIONS, INC.	)	**Case No. 01-1553**
SECURITIES LITIGATION	)	

CERTIFICATE OF SERVICE

I, Edward M. Posner, an attorney admitted to the bar of this Court, hereby certify that on June 18, 2001, I have caused two true and correct copies of the foregoing *Brief of Defendant-Appellee Ernst & Young LLP* to be served by hand delivery on

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