

**IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA**

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

:
: **MDL DOCKET NO. 1318**
: **NO. 98-CV-4286 (MK)**
:
:

**DEFENDANT ERNST & YOUNG LLP'S MEMORANDUM
IN SUPPORT OF ITS MOTION FOR SUMMARY JUDGMENT**

Edward M. Posner
Pa. Bar No. 19363
DRINKER BIDDLE & REATH LLP
One Logan Square
18th and Cherry Streets
Philadelphia, PA 19103-6996
(215) 988-2700

Lawrence S. Robbins
Gary A. Orseck
MAYER, BROWN & PLATT
1909 K Street, NW
Washington, DC 20006
(202) 263-3000

Patricia A. McGovern
ERNST & YOUNG LLP
787 Seventh Avenue
New York, NY 10019
(212) 773-3000

Attorneys for Ernst & Young LLP

Dated: October 16, 2000

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	iii
PRELIMINARY STATEMENT	1
SUMMARY OF ARGUMENT	4
ARGUMENT	8
I. E&Y IS ENTITLED TO SUMMARY JUDGMENT BECAUSE THE RECORD IS DEVOID OF EVIDENCE OF LOSS CAUSATION	8
A. To Establish Loss Causation, Plaintiffs Must Prove That The Security’s Loss In Value Resulted Directly From the Disclosure Of The Alleged Fraudulent Misrepresentation	11
B. E&Y Is Entitled To Summary Judgment Because The Record Is Devoid Of Evidence That The Alleged Misrepresentations Proximately Caused Plaintiffs’ Alleged Losses	15
C. Because IKON’s Stock Price Did Not Fall In Response To The “Corrective Disclosure,” The Alleged Fraudulent Misrepresentation Is Immaterial As A Matter Of Law	26
II. PLAINTIFFS’ 10b-5 CLAIM MUST FAIL AS A MATTER OF LAW BECAUSE THERE IS INSUFFICIENT EVIDENCE TO ESTABLISH THAT ERNST & YOUNG ACTED WITH SCIENTER	28
A. External Auditors (Such As E&Y) May Not Be Held Liable Under Rule 10b-5 Absent Sufficient Proof That Their Conduct Amounted To A “Pretended Audit”	28
B. The Record Emphatically Contravenes Any Suggestion That E&Y Performed “A Pretended Audit” On IKON’s 1997 Consolidated Financial Statements	32
C. Plaintiffs’ Specific Quarrels With The 1997 Audit Do Not Raise Any Triable Issue Of Fact Suggesting That E&Y Performed Only “A Pretended Audit”	37
1. Accounts Receivable Reserve	37

TABLE OF CONTENTS – Continued

	Page
2. Northern California	41
3. Southern District	44
4. IDS and IMS	46
5. Southern California	47
6. Failure to Record Certain Proposed Adjusting Entries	49
7. Remaining Districts	50
8. Plaintiffs’ Experts	51
III. E&Y IS ENTITLED TO SUMMARY JUDGMENT AS TO THE CLAIMS OF ALL PLAINTIFFS WHO ALLEGE THAT THEY PURCHASED IKON STOCK IN RELIANCE UPON IKON’S OCTOBER 15, 1997 EARNINGS RELEASE	53
CONCLUSION	59

TABLE OF AUTHORITIES

	Page(s)
Cases	
<i>In re Advanta Corp. Sec. Litig.</i> , 180 F.3d 525 (3d Cir. 1999)	27
<i>Anderson v. Liberty Lobby, Inc.</i> , 477 U.S. 242 (1986)	4, 26
<i>Anixter v. Home-Stake Prod. Co.</i> , 77 F.3d 1215 (10th Cir. 1996)	52
<i>Azrielli v. Cohen Law Offices</i> , 21 F.3d 512 (2d Cir. 1994)	50
<i>In re Bell Atlantic Securities Litig.</i> , No. CIV. A. 91-0514 <i>et al.</i> , 1997 WL 205709 (E.D. Pa. Apr. 17, 1997), <i>aff'd, per curiam</i> , 142 F.3d 427 (3d Cir. 1998)	26, 27, 30
<i>Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.</i> , 509 U.S. 209 (1993)	46
<i>In re Burlington Coat Factory Sec. Litig.</i> , 114 F.3d 1410 (3d Cir. 1997)	24
<i>Carley Capital Group v. Deloitte & Touche, LLP</i> , 27 F. Supp. 2d 1324 (N.D. Ga. 1998)	51, 52, 53
<i>Cashman v. Coopers & Lybrand</i> , 877 F. Supp. 425 (N.D. Ill. 1995)	53
<i>Celotex Corp. v. Catrett</i> , 477 U.S. 317 (1986)	4, 5
<i>Central Bank of Denver v. First Interstate Bank of Denver</i> , 511 U.S. 164 (1994)	49-53
<i>Chill v. General Elec. Corp.</i> , 101 F.3d 263 (2d Cir. 1996)	29
<i>Coates v. Heartland Wireless Communications, Inc.</i> , 26 F. Supp. 2d 910 (N.D. Tex. 1998)	13
<i>Copland v. Grumet</i> , 88 F. Supp. 2d 326 (D.N.J. 1999)	51
<i>Decker v. Massey-Ferguson, Ltd.</i> , 681 F.2d 111 (2d Cir. 1982)	27
<i>Ernst & Ernst v. Hochfelder</i> , 425 U.S. 185 (1976)	26, 28
<i>Fireman's Ins. Co. v. DuFresne</i> , 676 F.2d 965 (3d Cir. 1982)	4, 23
<i>In re Goodyear Tire & Rubber Co. Sec. Litig.</i> , No. 88-8633, 1993 WL 130381 (E.D. Pa. Apr. 22, 1993)	30

TABLE OF AUTHORITIES – Continued

	Page(s)
<i>Healey v. Catalyst Recovery of Penn., Inc.</i> , 616 F.2d 641 (3d Cir. 1980)	27, 39
<i>Huddleston v. Herman & MacLean</i> , 640 F.2d 534 (5th Cir. 1981)	10, 11, 12
<i>In re Kendall Square Research Corp. Sec. Litig.</i> , 868 F. Supp. 26 (D. Mass. 1994)	51
<i>Lovelace v. Software Spectrum, Inc.</i> , 78 F.3d 1015 (5th Cir. 1996)	36
<i>Marbury Mgmt., Inc. v. Kohn</i> , 629 F.2d 705 (2d Cir. 1980)	12
<i>Matsushita Elec. Indus. Co., v. Zenith Radio Corp.</i> , 475 U.S. 574 (1986)	4
<i>McLean v. Alexander</i> , 599 F.2d 1190 (3d Cir. 1979)	<i>passim</i>
<i>Miller v. New America High Income Fund</i> , 755 F. Supp. 1099 (D. Mass. 1991), <i>aff'd</i> , 36 F.3d 170 (1st Cir. 1994)	13
<i>Mishkin v. Ageloff</i> , No. 97-CIV-2690, 1998 WL 651065 (S.D.N.Y. Sep. 23, 1998)	51
<i>Oran v. Stafford</i> , No. 99-5184, 2000 WL 1268154 (3d Cir. Sept. 7, 2000)	24, 25
<i>In re Phillips Petroleum Sec. Litig.</i> , 881 F.2d 1236 (3d Cir. 1989)	10
<i>Petrucelli v. Bohringer & Ratzinger</i> , No. CIV. A. 91-2098, 1994 WL 81999 (E.D. Pa. Mar. 10, 1994)	47
<i>Queen Uno Ltd. Partnership v. Coeur D'Alene Mines Corp.</i> , 2 F. Supp. 2d 1345 (D. Colo. 1998)	27
<i>Robbins v. Koger Properties, Inc.</i> , 116 F.3d 1441 (11th Cir. 1997)	<i>passim</i>
<i>Robertson v. Allied Signal, Inc.</i> , 914 F.2d 360 (3d Cir. 1990)	4
<i>SEC v. First Jersey Sec., Inc.</i> , 101 F.3d 1450 (2d Cir. 1996)	50
<i>SEC v. Price Waterhouse</i> , 797 F. Supp. 1217 (S.D.N.Y. 1992)	29, 35
<i>Semerenko v. Cendant</i> , 223 F.3d 165 (3d Cir. Aug. 10, 2000)	<i>passim</i>
<i>Shapiro v. Cantor</i> , 123 F.3d 717 (2d Cir. 1997)	50

TABLE OF AUTHORITIES – Continued

	Page(s)
<i>In re Software Toolworks, Inc.</i> , 50 F.3d 615 (9th Cir. 1994)	53
<i>In re Software Toolworks, Inc. Sec. Litig.</i> , 789 F. Supp. 1489 (N.D.Cal. 1992)	29, 47
<i>Sundstrand Corp. v. Sun Chem. Corp.</i> , 553 F.2d 1033 (7th Cir. 1977)	27
<i>Vosgerichian v. Commodore Int'l</i> , 862 F. Supp. 1371 (E.D. Pa. 1994)	50, 51
<i>Weiner v. Quaker Oats Co.</i> , 129 F.3d 310 (3d Cir. 1997)	7
<i>Wells v. Monarch Capital Corp.</i> , 1996 WL 728125 (D.Mass. 1996), <i>aff'd</i> , 129 F.3d 1253 (1st Cir. 1997)	29
<i>In re Worlds of Wonder Sec. Litig.</i> , 35 F.3d 1407 (9th Cir. 1994)	<i>passim</i>
<i>Wright v. Ernst & Young LLP</i> , 152 F.3d 169 (2d Cir. 1998)	49, 50, 51, 52
<i>In re ZZZZ Best Sec. Litig.</i> , 864 F. Supp. 960 (C.D. Cal. 1994)	53

PRELIMINARY STATEMENT

Ernst & Young LLP (“E&Y”) respectfully submits this memorandum in support of its motion for summary judgment. As we show below, the record in this case simply does not permit a finding of liability against E&Y. The case should, at long last, come to an end.

It must be said, at the outset, that plaintiffs’ remaining allegations against E&Y are exceedingly narrow. Plaintiffs assert only that E&Y issued a false and misleading audit opinion on the fiscal year 1997 consolidated financial statements of IKON Office Solutions (“IKON”). That’s the long and short of plaintiffs’ case — and, for that reason, many of plaintiffs’ most incendiary claims about IKON management are not, and never have been, relevant to the case against E&Y. Thus, for example, it does not matter (and never has mattered) whether IKON’s press releases announcing quarterly earnings, financial projections, and management changes were accurate. See Second Amended Consolidated Class Action Complaint ¶¶ 50-100 (Ex. 3).¹ Indeed, with regard to the case against E&Y, it has never been an issue whether IKON’s financial statements for the First, Second, or even Third Quarter of 1998 were fairly stated; after all, E&Y opined only on IKON’s *year-end* financial statements. Nor is it of moment to the case *against E&Y* whether IKON’s CFO, Kurt Dinkelacker, sent a letter to IKON’s district presidents in the first quarter of 1998 — after E&Y completed its 1997 audit — requesting the districts to lower their reserves. See *id.* ¶¶ 24-27.

Indeed, even the allegations directed specifically at E&Y have been substantially narrowed since the case began. Perhaps most striking is plaintiffs’ understandable retreat from the most inflammatory allegation in their Complaint: 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, Mr. Dinkelacker, was “cooking the books.”

¹ All exhibits can be found in the Appendix to Defendant Ernst & Young LLP’s Motion for Summary Judgment.

As the Court doubtless recalls, that eye-catching assertion was the central “fact” offered by plaintiffs in opposition to E&Y’s Motion to Dismiss (Pl. Opp. at 16) (Ex. 12).

But discovery has given the lie to this allegation. As it now turns out, Peter Shoemaker, the supposed author of the “cooking the books” remark, denies saying anything of the sort, or for that matter saying or believing that there was *anything* wrong with IKON’s financial practices in 1997. Shoemaker 8/22/00 Tr. 7-22 (Ex. 14). Through an elaborate, Rube-Goldberg-like chain of hearsay remarks, a “cooking the books” remark filtered back to George Berry, E&Y’s coordinating partner on the IKON account. Mr. Berry thereafter assisted in an investigation of the remark conducted by the Ballard, Spahr law firm. It is undisputed that Ballard Spahr concluded — and Mr. Berry was duly informed — that the allegation (if made at all) was totally groundless. Berry Tr. 86-88 (Ex. 15); Response to Defendant’s Requests For Admission No. 45)(“Ballard Spahr informed Mr. Berry that . . . there was nothing to the ‘cooking the books’ allegation”) (Ex. 79). And to top it off, the so-called “May Registration Statement” incorporating E&Y’s audit opinion on the 1996 Financial Statements had actually become effective in *April 1997, fully nine days before Mr. Shoemaker even made whatever remark he made*. See April 15, 1997 SEC Order (Ex. 16); Stuart Tr. 10-22 (Ex. 17). So much for the plaintiffs’ misleading assertion — so central to their opposition to E&Y’s motion to dismiss — that “[t]he May 1997 Registration Statement became effective May 6, 1997,” by which time E&Y had “been informed at an Audit Committee Meeting that Dinkelacker was ‘cooking the books.’” Pl. Opp. at 16. Not surprisingly, plaintiffs have now stipulated to dismiss the Section 11 claim that had been grounded on these allegations.

So, too, have other allegations simply fallen by the wayside, as discovery has dispatched large blocks of the Second Amended Complaint. Plaintiffs no longer claim, for example, that E&Y improperly allowed IKON’s lease default reserve to be understated by \$32 million in 1997 (see 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.* ¶¶ 138-44. Nor do plaintiffs any longer assert any claims about improper revenue recognition under IKON’s Copy Management Program. *Id.* ¶¶ 29-34. At the time of the motion to dismiss, the Court treated all of these allegations as important to its conclusion that plaintiffs had adequately stated a claim. September 14, 1999 Memorandum and Order at 9-10, 14-16 (Ex. 13).

What, then, is left of the case that plaintiffs trumpeted to this Court when they opposed our motion to dismiss? Little more than a series of technical disagreements — propounded only by plaintiffs’ experts — with how E&Y made several highly judgmental auditing decisions during the course of the 1997 audit. Thus, for example, plaintiffs take issue with the adequacy of IKON’s reserve for doubtful accounts and E&Y’s auditing of that reserve; with E&Y’s decision not to consider certain audit differences as significant; and with the thoroughness of E&Y’s auditing work at several of IKON’s many locations. On each of these claims (and the others as well), the facts will not bear out the plaintiffs’ disagreements — but ultimately that is not the issue. Instead, the question before the Court on summary judgment is this: Have plaintiffs 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 v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979). Do plaintiffs 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.” Shorn of its inflammatory overtones, plaintiffs’ case lacks any proof — much less sufficient proof — of the requisite scienter. Nor can plaintiffs establish

“loss causation” — that plaintiffs’ losses, if any, on account of a drop in IKON’s stock price are the result of the misrepresentations they attribute to E&Y, and not some other cause. The time has come to call a halt to plaintiffs’ efforts to ratchet up to “fraud” what are, when all is said and done, merely technical disagreements with highly judgmental auditing decisions. Summary judgment is warranted.

SUMMARY OF ARGUMENT

Summary judgment is appropriate when the moving party shows that the record contains no evidence that creates material issues of fact. *Celotex Corp. v. Catrett*, 477 U.S. 317, 325 (1986); Fed. R. Civ. P. 56(c). Conversely, in order to defeat summary judgment, plaintiffs 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). “[A]n inference based upon a speculation or conjecture does not create a material factual dispute sufficient to defeat entry of summary judgment.” *Robertson v. Allied Signal, Inc.*, 914 F.2d 360, 382 n.12 (3d Cir. 1990); see also *Fireman’s Ins. Co. v. DuFresne*, 676 F.2d 965, 969 (3d Cir. 1982) (a party resisting summary judgment may not “rely merely upon bare assertions, conclusory allegations or suspicions.”). Moreover, the party opposing summary judgment “must do more than simply show that there is some metaphysical doubt as to the material facts” (*Matsushita Elec. Indus. Co., v. Zenith Radio Corp.*, 475 U.S. 574, 586 (1986)), and cannot rely on evidence submitted by an expert where the expert makes “an impermissible leap in logic” to reach his conclusion. *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994). Where the nonmoving party is unable to establish the existence “of an element essential to that party’s case, and on which that party will bear the burden of proof at trial,” summary judgment must be granted. *Celotex*, 477 U.S. at 322 (1986).

Plaintiffs, of course, have the burden of proof in this case; it therefore falls to them to meet the *Celotex* standard. And it will not suffice for plaintiffs to invoke the conventional chestnut that summary judgment should be sparingly granted. Indeed, the Supreme Court has emphatically stated just the opposite, remarking that 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.” *Id.* at 327. If, after a full and fair opportunity to establish its case, the party with the burden of proof lacks evidence sufficient to discharge that burden, it is not entitled to haul its opponent to trial.

Under these governing principles, and on multiple grounds, E&Y is entitled to summary judgment.

I. First and foremost, plaintiffs cannot establish “loss causation” in this case. To meet their burden on this element, plaintiffs propose to offer a circumstantial case premised on the notion that the drop in the price of IKON stock in the wake of the “corrective disclosure” of the alleged fraud in this case is a proxy for how much the stock had been unlawfully “inflated” during the months prior to the public disclosure of the fraud. Unfortunately for plaintiffs, however, there **was** no drop in the price of IKON stock after the \$110 million in charges were announced to the public on August 14, 1998. And under *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441 (11th Cir. 1997) — which this Circuit recently embraced in *Semerenko v. Cendant*, 223 F.3d 165 (3d Cir. Aug. 10, 2000) — that fact is absolutely fatal to plaintiffs’ case.

And plaintiffs know it. That is no doubt why one of plaintiffs’ damages experts felt it necessary to opine — at the eleventh hour, in his deposition but not his report — that the true “corrective disclosure” was made, not on August 14 (when IKON in fact told the world about the \$110 million in charges and the underlying problems that gave rise to them), but rather at some

earlier time (when the stock price actually declined). But plaintiffs' expert has offered no evidence, much less sufficient evidence, that on a single one of these earlier dates IKON breathed a word to the public about the prospect of these charges, or about the range of difficulties that had made the charges necessary.

II. In addition to proving loss causation, plaintiffs must also prove that E&Y made the alleged misrepresentation in this case with *scienter*. Under settled law, to prove *scienter* plaintiffs must establish that E&Y acted either knowingly or recklessly. Not even plaintiffs can bring themselves to attribute a *knowing* falsehood to E&Y, and so they are left to argue, as securities plaintiffs so often do, that the auditors were "reckless." But this Circuit is not bashful in separating the wheat from the chaff when it comes to allegations of "recklessness." To prove recklessness by an auditor, this Circuit has stated, 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." *McLean*, 599 F.2d at 1198. Or as another Circuit has put the point, plaintiffs must establish that "no reasonable accountant would have made the same decision if confronted with the same facts." *Worlds of Wonder*, 35 F.3d at 1426.

Plaintiffs cannot make such a showing. Far from conducting a "pretended audit," E&Y conducted a thorough, highly professional audit, expanding its budget and procedures to meet the needs and challenges of a company experiencing rapid growth and consolidation. Far from performing work "so flimsy as to lead to the conclusion that there was no genuine belief back of it," E&Y made reasonable auditing judgments on highly complex matters — reasonable judgments with which only plaintiffs' experts, alone among the witnesses in the case, will take issue. Nor can plaintiffs show that "no reasonable accountant would have made the same decision if confronted with the same facts." To the contrary, this is the one-in-a-million case in which another "reasonable

accountant” did **in fact** confront the same facts contemporaneously and did **in fact** conclude that it would have made the same decisions: Arthur Andersen LLP was hired at the direction of the IKON Board of Directors in the summer of 1998 to look over E&Y’s shoulders as it considered, among other things, whether IKON should restate its 1997 financial statements; and Arthur Andersen, as confirmed in sworn deposition testimony that the jury will hear (if need be), flatly stated that it would have audited IKON in essentially the same way.

Recklessness? Not even close.

III. In the alternative, partial summary judgment should be granted as to the claims of all plaintiffs who allege that they purchased IKON stock in reliance upon IKON’s October 15, 1997 earnings release. Plaintiffs seek to hold E&Y liable for that statement because the firm supposedly “approved” the earnings release before IKON issued it to the public. But 10b-5 liability can be imposed on an auditor only if he speaks, that is, only if he makes the misstatement in question. The Supreme Court has ruled out aiding-and-abetting liability of the sort plaintiffs seek to impose on E&Y.

ARGUMENT

I. E&Y IS ENTITLED TO SUMMARY JUDGMENT BECAUSE THE RECORD IS DEVOID OF EVIDENCE OF LOSS CAUSATION

To establish their claim of securities fraud under Rule 10b-5, plaintiffs must prove that E&Y (1) made misstatements or omissions of material fact; (2) with scienter; (3) in connection with the purchase or the sale of securities; (4) upon which plaintiffs reasonably relied; and (5) that plaintiffs’ reliance was the proximate cause of their injury. *Semerenko*, 223 F.3d at 174; *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 315 (3d Cir. 1997).

Plaintiffs allege that E&Y fraudulently misrepresented in its audit report on IKON's 1997 financial statements, filed with the SEC on December 24, 1997, that: (i) the financial statements were fairly presented in accordance with Generally Accepted Accounting Principles; and (ii) E&Y had conducted its audit in accordance with Generally Accepted Auditing Standards. According to plaintiffs, the 1997 financial statements overstated IKON's pre-tax income by \$54.9 million, which caused IKON's stock price to be artificially inflated throughout the class period. Plaintiffs' two damages experts, Professor Gregg A. Jarrell and Mr. R. Alan Miller, assert that the alleged artificial inflation caused damages of between \$399 and \$924 million.²

As in virtually all securities cases that are based on an allegation of artificial inflation, plaintiffs attempt to establish loss causation and damages through what amounts to circumstantial evidence. They point to a decline in the stock price toward the end of the class period. From there, they argue that the *fact* of the fall in the stock price is evidence of loss causation, because it tends to show that the alleged misrepresentation (before the truth came out) had in fact caused the stock to be overvalued. Next, the argument goes, the *amount* of the decline is evidence of the amount by which the stock price was inflated during the class period, prior to the corrective disclosure. The theory, then, is that the drop in the stock price serves as a proxy by which to measure the hypothetical "inflationary" effect that the alleged fraud had on the price of the stock.

In this case, plaintiffs' damages experts take as a given the opinion of plaintiffs' accounting experts — specifically, that IKON's 1997 year-end financial statements were overstated by \$54.9

² Presumably for shock value — or, perhaps, to give the jury some gargantuan damages number to bid down from — Mr. Miller also throws in three other potential damages figures, each in the neighborhood of \$1 billion. As we explain in our Motion *in limine* to Exclude Irrelevant and Inadmissible Damages Estimates, those figures do not even purport to measure any cognizable form of damages and should not be admitted into evidence.

million — and that E&Y’s audit report on those financial statements renders E&Y liable, at least in part, for any resulting damages to the plaintiff class. See Expert Report of Gregg A. Jarrell ¶¶ 21-22 (Ex. 1); Report of Anticipated Testimony of R. Alan Miller ¶ 15A (Ex. 2). They then chronicle the decline in the stock price from the beginning to the end of the Class Period, August 13, 1998, the day before the alleged “corrective disclosure.” On the latter date, August 14, 1998, IKON disclosed that it had taken charges to earnings, totaling \$110 million on a pre-tax basis, related to lease default reserves, accounts receivable reserves, internal control deficiencies, and other adjustments (Ex. 7).³

According to plaintiffs, it was this latter announcement that, in some form or another, “should have been made at the beginning of the Class Period” (Jarrell Rpt. ¶ 22), and that finally corrected the alleged fraud. See 2d Am. Cplt. ¶ 97 (“The components of these significant charges to earnings demonstrate the material effects of IKON’s improper accounting practices and internal control deficiencies . . . it is apparent that the improper inflation of leased equipment value, and failure to reserve in accord with IKON’s internal accounting policy described herein, significantly impacted earnings.”). Plaintiffs cite the decline in the stock price from the beginning to the end of the Class Period as evidence of the existence and degree of artificial price inflation, for which plaintiffs seek to hold E&Y responsible.

But there is a glaring, fundamental flaw in plaintiffs’ theory of the case, and it is a flaw that has resulted in judgment for the defendant in cases that are, in every relevant sense,

³ IKON described the categories of charges to earnings as (1) “increases to accounting estimates for lease default and accounts receivable reserves,” (2) adjustments stemming from a “breakdown in the execution of internal controls at four operating units,” (3) “adjustments at other operating units,” and (4) a “loss from an asset impairment in a Technology Services company....” The \$54.9 million that plaintiffs say IKON should have announced in 1997 is made up of charges and adjustments from the first three of the four categories.

indistinguishable from this one: There *was* no decline in the price of IKON stock in the wake of the “corrective disclosure”; instead, the drop in the stock price identified by plaintiffs and their experts *preceded* and was unrelated to the disclosure upon which plaintiffs base their fraud claim. Thus, as shown below, there is no triable issue of fact on the element of loss causation, and summary judgment is appropriate.

A. To Establish Loss Causation, Plaintiffs Must Prove That The Security’s Loss In Value Resulted Directly From the Disclosure Of The Alleged Fraudulent Misrepresentation

1. To satisfy the element of loss causation in a 10b-5 case, the plaintiff must prove “that the alleged misrepresentations proximately caused the decline in the security’s value.” *Semerenko*, 223 F.3d at 185 (citing *Robbins v. Koger*, *supra*, 116 F.3d at 1448). *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1244 (3d Cir. 1989) (loss causation requirement is satisfied only if “[t]he misrepresentations . . . touch[] upon the reasons for the investment’s decline in value.”) (citing *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981) (“If 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.”)).

As the Third Circuit has recently explained, to prove loss causation the plaintiff must establish *both* (i) that the “market price [] was artificially inflated due to a fraudulent misrepresentation” (*Semerenko*, 223 F.3d at 184); *and* (ii) “that the artificial inflation was actually ‘lost’ due to the alleged fraud.” *Id.* at 185. To meet the second part of the test, it is not sufficient merely to show that the price of the stock fell at some point after the fraudulent misrepresentation was made; rather, the plaintiff must prove that the stock price “dropped in response to disclosure of the alleged misrepresentations.” *Id.* at 186. “Where 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.” *Id.* at 185.⁴

Here, there is *no* evidence of any correlation between the alleged “corrective disclosure” that ended the Class Period (the August 14, 1998 press release in which the \$110 million charge against second and third quarter earnings was announced) and any decline in the stock price. As plaintiffs’ experts cannot help but acknowledge, whereas IKON’s stock price declined by nearly 75% 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 Jarrell Rpt. ¶¶ 44, 55. The evidence thus directly contradicts any suggestion that the stock “dropped in response to disclosure of the alleged misrepresentations.” *Semerenko*, 223 F.3d at 186. Because there is no cause-and-effect relationship between the alleged corrective disclosure and the stock’s decline, there is no claim under Section 10(b). Were it otherwise, “Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission.” *Huddleston*, 640 F.2d at 549.

2. The Eleventh Circuit’s holding in *Robbins v. Koger Properties* — the reasoning of which has been endorsed by the Third Circuit in *Semerenko* — is directly on point. 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.” *Ibid.* Koger’s common stock immediately fell by more than 50%. Some time *after* that announcement and the drop in the stock

⁴ In *Semerenko*, the Third Circuit concluded that the district court had prematurely dismissed the case on the pleadings, because the class *had* in fact alleged “that it suffered a loss when the truth was made known.” *Id.* at 185-86.

price, “it was discovered that the [1988, 1989 and 1990] audited financial statements were false.” *Ibid.* Following the public announcement of this discovery — the so-called “corrective disclosure” — Koger took a charge of more than \$100 million to its balance sheet. *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. 116 F.3d at 1445. As evidence of loss causation, the plaintiffs’ expert testified that Koger “would have had to cut its dividend 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 price had occurred *prior* to the “corrective disclosure,” there was no proof of loss causation. The district court denied the motion, and the jury awarded 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*, 640 F.2d at 549). 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 (quoting *Huddleston*, 640 F.2d at 549 and citing *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 718 (2d Cir. 1980) (Meskill, J., dissenting)).

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 1447-1448. 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.” *Id.* at 1448. 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 1448-49.⁵

Those are the controlling principles in this Circuit as well. And as we next show, for precisely the reasons articulated by the Eleventh Circuit in *Robbins*, E&Y is entitled to summary judgment for want of loss causation.

⁵ See also *Miller v. New America High Income Fund*, 755 F. Supp. 1099, 1108 (D. Mass. 1991) (dismissing fraud-on-the-market claim for failure to plead loss causation where there was no indication that the “stock dropped because the information fraudulently concealed suddenly came to light”), *aff’d*, 36 F.3d 170 (1st Cir. 1994); cf. *Coates v. Heartland Wireless Communications, Inc.*, 26 F. Supp. 2d 910, 922 (N.D. Tex. 1998) (plaintiffs had adequately pleaded “that the significant decline in price * * * was a result of disclosing the ‘truth’” because published listings confirmed that the stock had suffered a 43% drop on the first trading day after the end of the class period).

B. E&Y Is Entitled To Summary Judgment Because The Record Is Devoid Of Evidence That The Alleged Misrepresentations Proximately Caused Plaintiffs' Alleged Losses

Just as in *Robbins*, the decline in IKON's stock price *preceded*, and was *wholly unrelated to*, the alleged corrective disclosure on August 14, 1998 that marks the end of the Class Period. There is nothing in the record — and nothing pointed to by any of plaintiffs' experts — that suggests otherwise. To the contrary, the Rule 26 expert reports and deposition testimony confirm that the major decline in IKON's stock price — in April and June 1998 — occurred as a direct response to announcements about the company's transformation, increasing competition, narrowing margins, and limited availability of product — all problems the company encountered in 1998, having nothing whatsoever to do with the \$110 million in charges. Put another way, the stock price did *not* fall in response to the alleged August 14, 1998 “corrective disclosure,” nor in response to any earlier disclosure that suggested that the company's prior year financial statements had been misstated or that an additional \$54.9 million (or, for that matter, \$110 million) in charges were needed. Accordingly, plaintiffs cannot establish loss causation.

1. As Professor Jarrell explains (Rpt. ¶ 32), “modern finance theory holds that the market price of a stock reflects the expected discounted value of future cash flows to equity holders.” Through the use of an “events study,” Professor Jarrell purports to demonstrate how a series of disappointing announcements by the company in 1998 concerning the status of its operations dampened the market's view of IKON's “expected discounted . . . future cash flows,” thereby depressing the stock price.

In a section of his report entitled, “The Events Related to the Alleged Fraud,” Professor Jarrell lists three “material disclosures during the Class Period [that] revealed IKON's true financial condition to investors.” Jarrell Rpt. ¶ 39. Professor Jarrell identifies several public disclosures that

were made by IKON about its operating performance, and groups the disclosures and the associated declines in IKON's stock price into "three periods, called event windows, [which] measure the total stock-price decline." *Id.* First, he observes that on April 22, 1998, IKON announced that its second quarter earnings would be \$0.35 per share, rather than the \$0.38 per share that analysts had been expecting. *Id.* ¶ 41. As Professor Jarrell observes, "IKON cited several reasons for the earnings shortfall *including issues related to the transformation, competitive pressures, and costs associated with product rationalization.*" *Id.* ¶ 42 (emphasis added). The stock fell by \$9.37 that day, from \$34.62 to \$25.25. *Id.* ¶ 44. Jarrell cites no evidence that the drop in the stock price resulted from any suggestion that \$54.9 million (or \$110 million) in charges were needed — the announcement that plaintiffs claim should have been made at year end 1997. See also Report of Richard Ruback ¶ 24 (Ex. 4).⁶

Second, Professor Jarrell notes that on Friday, June 26, 1998, after the market had closed, IKON announced that its third quarter earnings would fall below the First Call consensus estimate of \$0.34 per share. Jarrell Rpt. ¶ 45. On the next trading day, June 29, 1998, the stock declined \$6.75 to close at \$15.31 per share. *Id.* ¶ 47. In a June 30 analyst report cited by Professor Jarrell, the analyst explained "that the same factors that led to the 2Q earnings shortfall, *namely weak equipment sales amid tough competition* from bigger industry rivals such as Xerox Corp. and Danka Business Systems PLC *and problems associated with integrating and absorbing recent acquisitions,* have negatively impacted the company's [third quarter] as well." *Id.* ¶ 48 (emphasis added); see also Ruback Rpt. ¶ 25 (citing analyst report (Ex. 5)) that attributed the earnings shortfall to "ongoing

⁶ As Prudential Securities observed in its April 27, 1998 report (Ex. 6), the shortfall was attributed to "lower average selling prices," "transition issues," and "product rationalization." See Ruback Rpt. ¶ 24.

operational disruptions, competitive selling price pressures, and portfolio pruning [which] continued to strain operating results”). Jarrell also observes that on July 27, 1998, at the beginning of his third “event window,” IKON’s stock declined from \$10.12 to \$8.75 per share immediately after the company announced that it was attempting “to identify the reasons for its disappointing earnings in recent months” and that “it would unveil steps to fix its struggling business.” Jarrell Rpt. ¶ 52.

Far from being “Events Relating to the Alleged Fraud,” *none* of these disclosures — from April 22 through August 4 — can be said to have signaled the market that IKON’s reported earnings for 1997 were misstated, or that the company might need to book some or all of the charges subsequently announced on August 14, 1998.⁷

Finally, Professor Jarrell turns to IKON’s August 14, 1998 press release, which marks the end of the purported class period. In the press release, IKON announced that it was taking a \$94 million pre-tax charge to third quarter earnings, and restating its second quarter earnings to reflect a one-time \$16 million pretax charge. *Id.* ¶ 54. In contrast to the earlier press releases, which revealed the company’s unexpectedly poor capacity to generate profits, the \$110 million charge related to *accounting* issues — primarily lease default reserves, accounts receivable reserves, and internal control deficiencies. 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.” Ruback Rpt. ¶ 45.

It is *these particular charges* (\$54.9 million of the \$110 million) that plaintiffs claim should have been announced by the company “no later than the dissemination of IKON’s financial results for fiscal 1997.” 2d Am. Cplt. ¶ 99; Jarrell Rpt. ¶ 71. For purposes of plaintiffs’ 10b-5 claim, the

⁷ Plaintiffs do not make any claim that IKON’s 1998 quarterly *earnings* shortfalls are attributable to IKON’s failure to record the posited \$54.9 million charge in 1997.

August 14, 1998 announcement of \$110 million in charges thus constitutes the “corrective disclosure” of the alleged fraud. See Jarrell Rpt. ¶ 97 (“The components of these significant charges to earnings demonstrate the material effects of IKON’s improper accounting practices and internal control deficiencies . . . it is apparent that the improper inflation of leased equipment value, and failure to reserve in accord with IKON’s internal accounting policy described herein, significantly impacted earnings.”).

But far from causing the price of IKON stock to *fall* (as had the disclosures relating to the company’s 1998 *operating performance*), “IKON’s stock price *increased* \$0.62 from \$9.31 a share on August 13, 1998 to close at \$9.9375 a share on August 14, 1998.” Jarrell Rpt. ¶ 55 (emphasis added). Thus, the “corrective disclosure,” as it is defined by plaintiffs, had *no* adverse effect on the price of the stock. See Ruback Rpt. ¶ 28 (“there is no evidence that the market reduced its valuation of IKON in response to the company’s disclosure of the \$110 million in charges”). See also Jarrell Tr. 124-125 (agreeing that “to the extent there was a statistically significant adverse price reaction to the information contained in the August 14 announcement, it all occurred *prior to August 14*”) (emphasis added) (Ex. 8).

2. From these undisputed facts, three important conclusions can be drawn. First, the decline in IKON’s stock price from the beginning to the end of the class period was a direct result of repeated announcements by the company that it was experiencing very specific business setbacks — transformation difficulties, increasing competition, narrowing margins, and limited product availability — and that it would be less profitable in the future than had been expected. As plaintiffs’ second damages expert, R. Alan Miller, observes in a section of his report entitled “Loss Causation,”

“In my opinion, the decline in IKON’s actual stock prices which occurred during the Class Period was very substantially caused by the repeated announcements of *lower operating earnings* than were expected by the investment community.”

Miller Rpt. ¶ 37 (emphasis added).

Second and relatedly, because the series of disclosures between April 22 and August 13, 1998 related only to IKON’s operating challenges (competition, margins, product availability, and the like) — and made no mention of the prospect of the \$110 million in charges — these pre-August 14 disclosures cannot be considered “corrective disclosures.” Indeed, even if one were to take, at face value, plaintiffs’ contention that a portion of the announced accounting charges should have been recorded at year end 1997, rather than in the third quarter of 1998, IKON’s 1998 *operating* performance would have been just as disappointing. The transformation would have been just as challenging, competition just as intense, margins just as narrow, and supply just as limited. Stated otherwise, IKON’s 1998 operating performance — good or bad — would have been no different had the company shown \$54.9 million less income on its books in 1997. Indeed, there is no evidence that a disclosure of the \$54.9 million in charges at the end of 1997 would have signaled a permanent impairment in IKON’s earnings, causing the stock price to fall, when disclosure of charges *twice as large* several months later had no such effect. See Ruback Rpt. ¶ 11. Accordingly, the decline in IKON’s stock price in response to IKON’s disclosures regarding its operating performance does not constitute the required showing that the stock price “dropped in response to disclosure of the alleged misrepresentations.” *Semerenko*, 223 F.3d at 186.

Finally, and dispositively, when IKON *did* announce that its second and third quarter reported earnings required a collective adjustment of \$110 million — due to accounting issues that plaintiffs claim should have been recognized in 1997 — the market did not react at all. As Professor Ruback reports, investment analysts “all treated the charges as a one-time, non- recurring item and

gave the charges limited attention in their reports.” Ruback Rpt. ¶41. Instead, the analysts “focused on the operations of IKON, the disappointing quarterly results, and the implications for future performance.” *Ibid.*

Accordingly, there is no triable issue of fact regarding loss causation because the record conclusively refutes the proposition that the stock price “dropped in response to disclosure of the alleged misrepresentations.” *Semerenko*, 223 F.3d at 186.⁸

3. No sooner did plaintiffs receive a copy of defendant’s expert reports than Professor Jarrell suddenly appreciated this fundamental flaw in his theory of the case. By the time of his deposition, Professor Jarrell had apparently concluded that the market’s shrug in reaction to the August 14, 1998 corrective disclosure does *not* preclude a finding that the alleged misrepresentation in connection with IKON’s 1997 financial statements proximately caused plaintiffs’ alleged damages. According to Jarrell, while there was no negative reaction in the market to the August 14

⁸ As noted above, Professor Ruback determined that there is *no* statistical evidence to support the proposition that the company’s August 14, 1998 announcement of \$110 million in charges had *any* negative effect on IKON’s stock price. See Ruback Rpt. ¶¶ 8, 15, 31. Plaintiffs’ experts agree. It follows that, had IKON announced a charge of *half* that amount (\$54.9 million) at year end 1997 (as plaintiffs claim they should have), the impact on the stock price would have been no greater. *Id.* ¶ 28. Notwithstanding “the absence of corroborating statistical information” (*id.* ¶ 46), Professor Ruback nonetheless postulates that in theory, if *loss causation* were otherwise established, the measure of *damages* flowing from the alleged misrepresentation could have been no more than \$31.5 million, which is the after-tax value of the charges that plaintiffs claim should have been taken at year end 1997. But the theoretical possibility of damages, as a matter of finance theory, does not change the reality that the August 14 announcement had *no* effect on IKON’s stock price, and thus the record does not support plaintiffs’ theory of loss causation. As a matter of Third Circuit law, plaintiffs accordingly cannot prevail. See *Semerenko*, 223 F.2d at 185 (“Where 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.”). See also *Robbins*, 116 F.3d at 1447 n.5 (“Proof of damages under the out-of-pocket rule is not proof of loss causation.”) (citations omitted).

disclosure, “the anticipation or leakage effect occurred approximately one month earlier.” Jarrell Tr. 223-224.

There is reason to be skeptical of this testimony. For one thing, Professor Jarrell’s deposition testimony contradicts his expert report, in which he characterized the period from June 26 to August 14, 1998 as an “information vacuum,” not one in which information was “leaked” to the market. Beyond that, the revised theory is too clever by half: if we don’t have the proof required by *Robbins* (because the stock price did not in fact decline once the corrective disclosure was made), why then it must be because the disclosure was “leaked” at an earlier point. And when was that leak? Naturally enough, just in time to coincide with pre-August 14, 1998 price declines.

Not only is that theory an obvious artifice, but as Professor Jarrell reluctantly had to concede, the record is devoid of evidence that news of the special charges did in fact leak into the market prior to August 14. When pressed, Jarrell testified that he believed that, prior to August 14, 1998, “there [wa]s concern over *operating earnings*,” but “I think it is unrealistic to think that the analysts are going to sit down and anticipate” the charges that were announced on August 14. Jarrell Tr. 60-61 (emphasis added). While he continued to insist that “it would have been very, very normal for analysts to expect charges” relating to the accounting issues (*id.* at 64-65), he was unable to identify any evidence that they anticipated the charges that plaintiffs claim should have been booked at year-end 1997. See *id.* at 64: (“Q: [W]as information disclosed to the market that IKON would need to take charges to address the matters identified in Exhibit 5 of the Devor and Carmichael report? A: The answer — I’m sympathetic to your — the answer is I don’t know.”) See *id.* at 66 (“Q: [W]as it revealed by anyone to the market that the company was going to have to take charges to address the specific matters set forth in Exhibit 5 of the Devor and Carmichael report? A: I don’t remember

...”).⁹ What is more, plaintiffs’ second damages expert, Mr. Miller, conceded that the market had **not** anticipated the charges that IKON announced at the end of the Class Period. When asked, point blank, whether he agreed that “the information disclosed on August 14th had **not** been anticipated by the market,” he responded, “[t]hat’s correct, that’s the implication one might get from looking at this sort of data.” Miller Tr. 431 (Ex. 9). Under *Robbins v. Koger Properties*, that concession alone is fatal to plaintiffs’ case.

Nor was Professor Jarrell able to point to any evidence that the market anticipated that the company might have to restate its 1997 financial statements. See Jarrell Tr. 71 (“Q: Do you have any affirmative evidence that up through and including August 13 the market believed that there was a need to restate the 1997 financial statements? A: No, I don’t think so.”) See *id.* at 70-71 (“If I would have seen it I would have flagged it.”). Thus, both Jarrell and Miller concluded that there was no evidence that the market anticipated, in advance of August 14, 1998, the specific charges that were taken by IKON on that date.

At his deposition, Professor Jarrell did identify certain analyst reports, issued on July 6 and July 9, 1998, that, in his view, signaled to the market that some *undefined* charges might be taken by IKON in the future. *Id.* at 77-94.¹⁰ But even accepting as true Professor Jarrell’s assertion that

⁹ Exhibit V to the Rule 26 Statement of plaintiffs’ liability experts, Harris L. Devor and Douglas R. Carmichael (Ex. 10), sets forth the components of the \$54.9 million by which plaintiffs claim IKON’s 1997 pretax income was overstated.

¹⁰ At his deposition, Jarrell also alluded to a May 27, 1998 report by Salomon Smith Barney, entitled, “Could More Cost-Cutting Be in the Cards?” Jarrell Tr. 80. Jarrell suggested that the article might have foreshadowed the accounting charges taken on August 14, 1998, because “a major way” that a company cuts costs “is with taking charges.” *Ibid.* Nothing in this report remotely suggests concerns about accounting issues, and plaintiffs cannot legitimately claim that an analyst’s mention of potential “cost-cutting” amounted to a “corrective disclosure” with respect to the alleged misrepresentations concerning IKON’s year-end financial statements. Indeed, Jarrell himself would not go so far as to characterize the May 27 report as a corrective disclosure, asserting

these reports, issued before August 14, 1998, were “consistent with an expectation that charges are a distinct possibility” (*id.* at 86), they simply confirm the total lack of evidence of loss causation. As with the August 14, 1998 “corrective disclosure,” there was no statistically significant adverse reaction by the market to any of the analyst reports that Jarrell cites. See Jarrell Rpt. Ex. D6. While the stock price declined by what Jarrell considers an immaterial amount on July 6, it actually *rose* by over 6% on July 9, 1998. *Ibid.* Accordingly, to the extent that plaintiffs purport to rely on the July 6 and July 9, 1998 analyst reports as *additional* “corrective disclosures,” it remains true that there is no “drop[] in response to disclosure of the alleged misrepresentations.” *Semerenko*, 223 F.3d at 186.¹¹ And again, under *Robbins v. Koger Properties*, that is fatal to plaintiffs’ case.

Jarrell’s event study confirms that he too determined that the July 6 and July 9 analyst reports were not material to his analysis. In his report, Jarrell identifies three event windows during which, he claims, information was disclosed to the market that corrected the alleged fraud: (i) April 22, 1998; (ii) June 26 - 29, 1998; and (iii) July 27 - August 17, 1998. Thus, he states that “the information disclosed to the market on April 22, 1998, June 26-29, 1998 and July 27-August 17, 1998” — that is, during the three event windows — “caused the traded price of Ikon to decline in a statistically significant manner and that the information revealed to the market included specific problems that Plaintiffs allege should have been disclosed by IKON at the beginning of the Class Period.” Jarrell Rpt. ¶ 63.

instead the “leakage period . . . starts on July 27.” Jarrell Tr. 123-24.

¹¹ At the deposition of E&Y’s damages expert, Professor Ruback, plaintiffs’ counsel insisted that the July 6 and July 9, 1998 analyst reports refute Ruback’s observation that there was no corrective disclosure that caused a decline in the stock price prior to August 14, 1998. But Ruback rejected that suggestion, stating that there was no “evidence that the stock price moved in response to these pieces of information.” Ruback Tr. 330-331.

But the July 6 and July 9, 1998 analyst reports do *not* fall within any of these “windows,” for the obvious reason that they had no effect on the stock price. As Jarrell confirmed at his deposition, other than during the three windows, “there are no other statistically significant negative stock price effects in the period that we discussed between April and the middle of August 1998 *which I can confidently attribute to something related to the fraud or which I have attributed to fraud in connection with the report.*” Jarrell Tr. 58-59 (emphasis added). See *id.* at 59-60 (under Jarrell’s event study approach, if events “are material they should be included” in the windows).

In the end, Professor Jarrell offered nothing better than a self-serving tautology in defense of his opinion: precisely because there was no statistically significant reaction to the August 14, 1997 announcement, there *must* have been “a leakage period that precede[d] it,” thereby resulting “in the negative stock price reaction in June and April.” *Id.* at 123-124. Put differently, Jarrell assumed (again, at his deposition, but not in his expert report) that the market must have anticipated IKON’s August 14 announcement of a one-time charge because, absent that self-serving hypothesis, how can plaintiffs otherwise explain the total lack of any statistically significant reaction to the announcement? See *id.* at 450 (“it is much more reasonable to assume that the negative impact of these charges was anticipated than it is to say that . . . there was no reaction.”).

In the face of a motion for summary judgment, however, it is not nearly enough for plaintiffs to “assume,” as Professor Jarrell does, that the decline in IKON’s stock price *prior* to the announcement of special charges on August 14 was proximately caused by the market’s anticipation of such charges. See *Fireman’s Ins.*, 676 F.2d at 969 (a party resisting summary judgment may not “rely merely upon bare assertions, conclusory allegations or suspicions.”). Nor does it suffice to say, as Professor Jarrell admitted in an unguarded moment in his deposition, that only “God knows what [analysts] were saying to their clients over the phone and so forth” about IKON’s prospects.

Jarrell Tr. 70. No — before plaintiffs should be permitted to roll the dice with a jury, seeking hundreds of millions, they must have *proof* of loss causation, not merely some fanciful speculation about what only “God knows.” There is no disputed issue of material fact, and there is no “battle of the experts” to be sifted through by a jury. The issue of loss causation should be resolved now, at the summary judgment stage, based on a record (the daily listings of the New York Stock Exchange) that is not open to dispute.

C. Because IKON’s Stock Price Did Not Fall In Response To The “Corrective Disclosure,” The Alleged Fraudulent Misrepresentation Is Immaterial As A Matter Of Law

As discussed above, both sides and their experts agree that there was no statistically significant market reaction to the August 14, 1998 disclosure that ended the Class Period.¹² And because the stock price did not fall in response to this “corrective disclosure,” E&Y is entitled to summary judgment for the additional reason that the alleged fraudulent misrepresentation is immaterial as a matter of law. As the Third Circuit explained just last month,

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, No. 99-5184, 2000 WL 1268154, at *4 (3d Cir. Sept. 7, 2000) (quoting *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997)). Applying that common

¹² Mr. Miller may, perhaps, be an exception because, in his view, the fall in the price of IKON stock in the weeks following the August 14 announcement was the result of the announcement itself. Miller performed no statistical testing to reach this conclusion, however — a step that, according to Professor Jarrell, is essential to drawing any such conclusion. Jarrell Tr. 124-25. For his part, Jarrell agreed that the price effects of the August 14 announcement were fully absorbed by August 17 and were statistically insignificant. *Ibid.*

sense principle, the Court of Appeals 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. 2000 WL 1268154, at *5. 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 the Court of Appeals held was “dispositive of the question of materiality.” *Ibid.* Accordingly, the Third Circuit affirmed the district court’s dismissal of the class’s 10b-5 claim because the alleged misrepresentation was immaterial as a matter of law.

Professor Jarrell concedes the very point made by the Third Circuit in *Oran*. As he explained in his expert report, the absence of an adverse stock price reaction indicates that the “new information” disclosed on that day is not material:

Generally, two factors must be present to support a finding of materiality based on events studies. First, there must be a public disclosure of new information. *Second, there must be a statistically significant return (net of market or industry movements) which is correlated to the release of new information* If the stock price movement (return) is outside of the stock’s normal volatility (for a given statistical confidence limit), then the return is said to be “statistically significant” and the price movement is regarded as being material.

Jarrell Rpt. ¶ 36 (emphasis added). As is set forth above, the August 14, 1998 disclosure by IKON of accounting adjustments to its reported results for the second and third quarters (part of which, plaintiffs say, should have been announced in 1997) certainly “had no appreciable negative effect on the company’s stock price.” *Oran*, 2000 WL 1268154, at *5. Accordingly, the alleged misrepresentation was immaterial as a matter of law, and plaintiffs’ 10b-5 claim therefore fails.

II. PLAINTIFFS' 10b-5 CLAIM MUST FAIL AS A MATTER OF LAW BECAUSE THERE IS INSUFFICIENT EVIDENCE TO ESTABLISH THAT ERNST & YOUNG ACTED WITH SCIENTER

A. External Auditors (Such As E&Y) May Not Be Held Liable Under Rule 10b-5 Absent Sufficient Proof That Their Conduct Amounted To A "Pretended Audit"

Plaintiffs have alleged a single misstatement in this case: that E&Y improperly provided a "clean" audit opinion on IKON's 1997 year-end financial statements. To prevail on their Section 10(b) claim, plaintiffs must prove that E&Y made this alleged misrepresentation with scienter. *In re Bell Atlantic Securities Litig.*, No. CIV. A. 91-0514 *et al.*, 1997 WL 205709, at *26 (E.D. Pa. Apr. 17, 1997), *aff'd, per curiam*, 142 F.3d 427 (3d Cir. 1998). See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976) (in rejecting section 10(b) claim based on negligence, stating that scienter under Section 10(b) is "a mental state embracing an intent to deceive, manipulate, or defraud."). Accordingly, in order to defeat summary judgment, plaintiffs must produce specific facts sufficient to carry their burden of proof that E&Y knowingly or recklessly misrepresented in its opinion that IKON's fiscal 1997 financial statements were fairly stated in compliance with GAAP. See *Anderson*, 477 U.S. at 252 ("the inquiry involved in a ruling on a motion for summary judgment * * * necessarily implicates the substantive evidentiary standard of proof that would apply at the trial on the merits").

Plaintiffs have not even intimated, much less proved, that E&Y *knowingly* made any misrepresentations. That leaves "recklessness" as plaintiffs' allegation of choice. But this Circuit has emphatically held that "recklessness" under Section 10(b) entails significantly more than negligence, or even egregious negligence. In particular, "reckless" conduct is conduct that involves an "extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers and 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 (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)); 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 where “[p]laintiffs’ allegations, even if true, would not demonstrate an ‘extreme departure’ from the standards of ordinary care.”) (quoting *McLean*). Recklessness, in short, borders on intentional or conscious misconduct. See *Healey v. Catalyst Recovery of Penn., Inc.*, 616 F.2d 641, 649 (3d Cir. 1980) (recklessness in the context of Section 10(b) is “relatively close to intentional conduct”); *McLean*, 599 F.2d at 1192 (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.”) (internal quotations and citations omitted).

To conclude that an auditor has acted recklessly, a plaintiff must therefore demonstrate that an auditor’s conduct “approximate[s] an actual intent to aid in the fraud being perpetrated by the audited company.” *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 121 (2d Cir. 1982). Negligence, even if it is “gross, grave or inexcusable,” is simply not sufficient. *McLean*, 599 F.2d at 1198; *Bell Atlantic*, 1997 WL 205709, at *26; *Queen Uno Ltd. Partnership v. Coeur D’Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1356 (D. Colo. 1998) (“Recklessness in private securities fraud action is not * * * mere carelessness or even gross negligence; it instead embraces a conscious state of mind that is inherently deceptive.”) (internal quotations omitted).

This Circuit has scrupulously applied those principles. In *McLean v. Alexander, supra*, for example, the Court reversed a district court’s judgment against an auditing firm in a section 10b-5 case because the plaintiff had not established that the defendant acted recklessly. In that case, the plaintiff challenged the auditor’s certification of an audited financial statement, claiming (as plaintiffs do here) that the balance sheet overstated accounts receivable. *Id.* at 1195. Relying on

Ernst & Ernst v. Hochfelder, supra — in which the Supreme Court held that “inexcusable negligence” was insufficient to establish scienter under section 10(b) — the Court held 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.” *McLean*, 599 F.2d at 1198 (internal quotations omitted, emphasis added). Under that standard, the Court held that the district court’s liability finding could not be sustained. Perhaps “[i]f we were applying a negligence standard,” the Court observed, “we would agree [with the trial court].” *Id.* at 1200. But “[s]uch a holding,” the Court concluded, “would obliterate the distinction between tortious conduct requiring scienter, which the *Hochfelder* construction of § 10(b) demands, and negligence, which *Hochfelder* found insufficient.” *Ibid.* Instead, 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.”** *Id.* at 1198 (emphasis added; internal quotations omitted). That is a high bar indeed, and this Circuit has not hesitated to enforce it.

Nor is this Circuit alone in insisting on compelling proof of truly reckless behavior. In *In re Worlds of Wonders Sec. Litig., supra*, for example, the Ninth Circuit affirmed the district court’s grant of summary judgment for an auditing firm. Although plaintiffs had presented an expert affidavit stating that the company’s financial statements improperly recognized revenue in violation of GAAP, the court noted that scienter requires more than just a misapplication of accounting principles or the second-guessing of accounting decisions. 35 F.3d at 1426. Instead,

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). *See, e.g., SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1241 (S.D.N.Y. 1992) (recognizing that reasonable disagreements with respect to any given item in a company's balance sheet do not support an inference of recklessness or fraud, and refusing to grant injunction to SEC where "at best the Commission has established that in some instances a reasonable accountant, would, might or should have handled the matter differently"); *Chill v. General Elec. Corp.*, 101 F.3d 263, 270 (2d Cir. 1996) (in affirming dismissal of complaint for failure to allege scienter, stating that "[a]llegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent, are not sufficient to state a securities fraud claim.").

We recognize, of course, that scienter is a fact-intensive inquiry and that, in some instances, it may not be suitable for disposition on summary judgment. That is no doubt what plaintiffs will retort, and it is a common refrain indeed. But the fact is, courts have not hesitated to grant summary judgment for auditors (and other defendants) in securities fraud cases where the plaintiff fails to produce sufficient evidence of the defendant's scienter. *See, e.g., Worlds of Wonder*, 35 F.3d at 1407 (plaintiffs' expert declaration that auditor acted with scienter not sufficient to survive summary judgment); *Wells v. Monarch Capital Corp.*, 1996 WL 728125, *15-16 (D.Mass. 1996), *aff'd*, 129 F.3d 1253 (1st Cir. 1997) ("The summary judgment record fails to show that Ernst & Young acted intentionally or recklessly to defraud the investing public by issuing its March 1990 Audit Opinion."); *In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489, 1502-1505 (N.D.Cal. 1992) ("The fact that on some occasions [the auditor] concluded that the negative information presented was outweighed by contrary information might show bad judgment, but nothing Plaintiffs

have put forth shows such an extreme departure from the standards of ordinary care that [the auditor] must have been aware of the danger of misleading the public.”) (internal quotations omitted).¹³

B. The Record Emphatically Contravenes Any Suggestion That E&Y Performed “A Pretended Audit” On IKON’s 1997 Consolidated Financial Statements

Plaintiffs cannot *conceivably* prove at trial, as they must, that E&Y’s audit work amounted to “a pretended audit.” *McLean*, 599 F.2d at 1198. 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. Declaration of James Mulherin ¶ 7 (Attachment A hereto). In April, the coordinating partner for the IKON engagement, George Berry, the engagement partner, Jim Mulherin, and the Senior Manager on the engagement, Carmen Nepa, had several meetings with other E&Y personnel to design the audit scope and procedures, as well as meetings with IKON personnel to discuss the company’s needs and expectations. As a result, an audit planning report was submitted to the Audit Committee of IKON’s Board of Directors on April 30, 1997. *Id.* ¶ 8.

In order to plan the audit, E&Y’s engagement team evaluated IKON’s internal controls as well as a host of other factors, including, but not limited to, the results of prior year audits at IKON and IKON’s fiscal year 1997 internal audits, the nature of IKON’s business, and IKON’s transformation and acquisition programs. Mulherin Decl. ¶¶ 10-11. As a result of this extensive

¹³ See also, *e.g.*, *In re Bell Atlantic Corp. Sec. Litig.*, 1997 WL 205709, at *30 (granting defendant’s summary judgment motion because plaintiffs had failed to establish scienter, among other things, and stating that “the mere publication of inaccurate accounting figures (or failure to follow GAAP) without more * * * does not establish scienter.”); *In re Goodyear Tire & Rubber Co. Sec. Litig.*, No. 88-8633, 1993 WL 130381, at *17 (E.D. Pa. Apr. 22, 1993) (in granting defendant’s motion for summary judgment for failure to prove, among other things, scienter, court noted that “plaintiffs’ evidence does not demonstrate an extreme departure from the standards of ordinary care * * *”).

planning, E&Y determined that it would perform specific scope audits at eight of IKON's units, as well as procedures at IKON's corporate headquarters. *Id.* ¶ 12. While E&Y judged IKON's internal controls to be effective, it chose not to rely upon them and instead performed substantive procedures and analytical tests on the balances. Following a methodology recognized as appropriate under GAAS, E&Y performed some procedures prior to the end of the fiscal year and rolled forward the results of those procedures based on more limited testing at the end of the fiscal year. *Ibid.*

Even after this extensive planning, however, E&Y's interim procedures identified issues that required further investigation and testing. Thus, although E&Y budgeted a total of 8,250 hours to the audit, E&Y ultimately devoted over *ten-thousand* hours. EY 285115 (Ex. 19). In IKON's Southern District, for example, E&Y personnel devoted 30 percent more hours to their audit work than originally planned. (EYDF 006140) (Ex. 20), while in IKON's Northern California District E&Y auditors performed 70 percent more work than originally budgeted. EYDF 006139 (Ex. 21). No reasonable jury could possibly conclude that this herculean effort "amounted to no audit at all." *Worlds of Wonder*, 35 F.3d at 1426.

Second, plaintiffs will be unable to show that "no reasonable accountant would have made the same decisions if confronted with the same facts." *Ibid.* Indeed, the record shows that another "reasonable accountant" — in particular, Arthur Andersen LLP, a nationally recognized Big Five accounting firm, two of whose partners have provided deposition testimony to this effect — concluded contemporaneously that it *would* have reached "the same decision * * * confronted with the same facts."

During the summer of 1998, Arthur Andersen — ordinarily a fierce competitor of E&Y — was engaged at the direction of the IKON Board of Directors to look over E&Y's shoulder when

the so-called “Special Procedures”¹⁴ were being performed by IKON and E&Y. As its first step in the process, Arthur Andersen conducted a thorough review of the work papers created by E&Y during its audit of IKON’s 1997 financial statements. McAleer Tr. 139-141 (Ex. 22). The Arthur Andersen partners and staff spent hundreds of hours conducting this task, during the course of which they reviewed, among other things, E&Y’s site-visit files, internal audit reports, and the report of the audit of IKON Capital. *Id.* at 138-141; Costello Tr. 113 (Ex. 23). While this thorough review obviously did not constitute an “audit” pursuant to the governing standards, the team found nothing in E&Y’s work “that would be a significant issue” regarding the quality of the work. McAleer Tr. 142. See Costello Tr. 205 (“There’s nothing that I’m aware of that Arthur Andersen was aware of that was viewed to be a significant deficiency.”). Indeed, Arthur 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.” *Id.* at 144; Costello Tr. 234 (same). Not only that, the principal hands-on Arthur Anderson partner on the engagement determined that, had he been in charge of the 1997 IKON audit, he is “[n]ot sure we would do much differently given [the] scope and size of the company.” *Id.* at 148; Costello Tr. 211.

Andersen didn’t just conclude that it wouldn’t have done much differently had it been confronted with the same facts. It also concluded that nothing it saw in its review of the 1997 work papers or in its review of the Special Procedures suggested that the 1997 financial statements were materially misstated. At the conclusion of the special procedures, IKON took a charge against income of \$110 million, which was allocated to the second and third quarters of 1998. Plaintiffs

¹⁴ The Special Procedures were undertaken in the summer of 1998 to fully assess IKON’s financial position and determine whether charges were warranted.

now allege that \$54.9 million of this amount should have been recorded as of September 30, 1997. But Arthur Andersen reviewed the bases for the special charges and did *not* disagree with the allocation, nor did it disagree with the decision not to restate the 1997 financial statements. McAleer Tr. 155-156, 167-168, 171, 182-183; Costello Tr. 218, 221.

Thus, having thoroughly reviewed E&Y's audit work on the 1997 financial statements, the conduct of the Special Procedures, and the results of the Special Procedures, Arthur Andersen reported to its client, the IKON Board of Directors, that it concurred that IKON's 1997 financial statements did *not* require restatement. In the words of James Birle, Chairman of the Audit Committee, Arthur Andersen gave E&Y a "passing grade." Birle Tr. 109 (Ex. 24). Andersen understood that it had been charged with notifying the Board if it disagreed with the allocation of adjustments (McAleer Tr. 155-156; Costello Tr. 223), and the Board expected Anderson to express any disagreement it may have had. Forese Tr. 90-91 (Ex. 25). Yet Andersen expressed no disagreement. To the contrary, Andersen reported to the Board that it found nothing that caused it to question the adequacy and professionalism of the work performed by E&Y. In light of these uncontradicted conclusions, plaintiffs will not be able to show that no reasonable accountant could have come to the same conclusions as did E&Y. Simply put, no well-instructed jury could conclude that E&Y's work was so deficient as to constitute "a pretended audit." *McLean*, 599 F.2d at 1198.

Like the claims in both *McLean* and *Worlds of Wonder*, plaintiffs evidently believe that IKON's financial statements did not comply with GAAP. Plaintiffs also proffer different interpretations of what GAAS required. But there simply is no basis on this record (much less sufficient evidence) to present to a jury the bald allegation of fraudulent intent. As we next show, a review, area by area, of the specific components of plaintiffs' case (that is, those still remaining after discovery) confirms this point.

C. Plaintiffs' Specific Quarrels With The 1997 Audit Do Not Raise Any Triable Issue Of Fact Suggesting That E&Y Performed Only "A Pretended Audit"

What little remains of plaintiffs' case consists of a series of highly technical quarrels with IKON's treatment of several highly judgmental accounting issues in its 1997 financial statements, and in turn the equally (if not more) highly judgmental decisions made by E&Y in auditing those financial statements. These, of course, are precisely the kinds of decisions that courts are loathe to second-guess, much less to characterize as so utterly egregious "as to lead to the conclusion that there was no genuine belief back of it." *McLean*, 599 F.2d at 1198. That is quintessentially true of plaintiffs' single largest claim — that E&Y recklessly opined that IKON's accounts receivable reserve was adequate under GAAP. But it is likewise true of their other allegations — that E&Y's audit teams in Northern California, the Southern District, and IDS did not properly assess the adequacy of each unit's accounts receivable reserve; that E&Y did not verify the reconciliation of certain intercompany accounts; and that E&Y did not insist that IKON book in its year-end financial statements the preliminary "findings" contained in an internal audit performed at the IKON-Southern California marketplace.

1. Accounts Receivable Reserve

In the view of plaintiffs' experts, fully \$20.698 million of the alleged \$54.9 million overstatement of IKON's 1997 pre-tax income is on account of IKON's under-accrual in the allowance for doubtful accounts. Rule 26 Statement of Harris L. Devor and Douglas R. Carmichael ¶ 17. But as even plaintiffs' 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. Devor Tr. 305-06 (Ex. 74); Carmichael Tr. 344 (Ex. 73). 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., 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, plaintiffs’ contrary view rests on little more than the fact that the reserve was less than what IKON’s *internal policy* required: The \$20.698 million supposed understatement is simply the amount by which IKON was out of compliance with *IKON policy* (adjusted for unapplied cash) as of September 30, 1997. *Id.* ¶ 24, EY 210897 (Ex. 26). IKON prepared its consolidated financial statements in accordance with GAAP, which it did not in all respects equate with its internal policy. And as every E&Y witness, virtually every IKON witness, Arthur Andersen (which concurred in the decision not to restate IKON’s 1997 financial statements, and which recognized that the IKON consolidated reserves were less than “policy” (McAleer Tr. 74, 111, 116, 166)), and E&Y’s accounting expert (Lynford Graham, from the national accounting firm of BDO Seidman, LLP) — indeed, just about everyone other than plaintiffs’ two accounting experts — have explained, a departure from IKON policy is not necessarily a failure to comply with GAAP.

Why is that so? 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 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 33 $\frac{1}{3}$ percent of the amount of receivables outstanding, or aged, 91-150 days, 66 $\frac{2}{3}$ percent of the amount aged 151 to 180 days, and 100 percent of the amount aged greater than 180 days. EY 562456 (Ex. 51). 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 served many functions: they encouraged IKON district management to be aggressive in collecting receivables and selling inventory (by requiring steep reserves if management failed to do so); they ensured that all uncollectible amounts would be fully reserved; they promoted uniformity across the many disparate IKON entities; and they served a variety of other purposes. Stuart Tr. 60-62; Dinkelacker Tr. 44 (Ex. 27); Mulherin Decl. ¶¶ 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. Nepa Tr. 532-37 (Ex. 29); Mulherin Decl. ¶ 31. It does *not* require application of a single, mechanical formula. See *Lovelace v. Software Spectrum, Inc.*, 78 F.3d 1015, 1021 (5th Cir. 1996) ("[A]n 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 did **not** necessarily mean a failure to comply with GAAP.¹⁵ Instead, nearly to a person, they recognized that 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. But it bears repeating that the standard is **not** whether plaintiffs on the one hand, or IKON, E&Y and Arthur Andersen on the other, ultimately have the better view of IKON's reserve estimates. Instead, for plaintiffs 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 a jury should not be permitted to consider it.

¹⁵ Dinkelacker Tr. 44; Dillon Tr. 117-118 (Ex. 30); Stuart Tr. 60 Royce Tr. 387-88 (Ex. 31), 211; Yergler Tr. 154-155 (Ex. 32); Shoemaker, 8-22-00, Tr. 110; Sheehan Tr. 231-232 (Ex. 33); Kopy Tr. 49-50 (Ex. 34); DeBoer Tr. 186-187 (Ex. 35); Koether Tr. 127 (Ex. 36); Deverall Tr. 115-116 (Ex. 37); Hooper Tr. 114 (Ex. 38); Mulherin Tr. 103 (Ex. 39); Nepa Tr. 811; Berry Tr. 159; Lilholt Tr. 148, 325 (Ex. 40); Cain Tr. 206 (Ex. 41); Burnett Tr. 43 (Ex. 42); Yanis Tr. 198 (Ex. 43); McElderry Tr. 73; Dougherty Tr. 138-139 (Ex. 45); Peluso Tr. 66 (Ex. 46); Spencer Tr. 36 (Ex. 47); Chekian Tr. 76 (Ex. 48); Chan Tr. 86 (Ex. 49). Even Mr. Royce, whom plaintiffs' experts rely on for the proposition that IKON policy is the equivalent of GAAP (see Devor Tr. 187), actually testified repeatedly that IKON policy is different from GAAP. Royce Tr. 45; Royce Tr. 387-388, 393-394, 423. Indeed, Royce authored a memo that distinguished IKON policy from GAAP in considerable detail. See IK 053386-88 (Ex. 50). Plaintiffs' reliance on the Accounting Policy Manual section relating to accounts receivable is similarly misplaced. See Devor/Carmichael Report ¶ 20. 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. 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” would have believed that GAAP could not differ from IKON policy.

The same holds true for the balance of plaintiffs' major allegations. In fact, when one focuses on the four IKON units that draw most of plaintiffs' fire — Northern California, the Southern District, IKON Document Services (IDS), and IKON-Southern California — there is simply no evidence, much less sufficient evidence, that E&Y's auditors acted with scienter. To the contrary, E&Y's procedures at these locations demonstrate that E&Y was conscientious and thorough and negate any inference that E&Y's audit amounted to "no audit at all." *Worlds of Wonder*, 35 F.3d at 1426.

2. Northern California

E&Y included the Northern California district in its audit scope for 1997 even though E&Y had performed procedures at the largest operating unit of the district — Taylor Made Office Systems — for fiscal year 1996. Although E&Y's normal procedure was to rotate audit coverage among IKON districts from year to year (Mulherin Decl. ¶ 13), E&Y recognized that the conversion of Taylor Made to the SAP computer system would be a challenge for the operating unit and therefore performed audit procedures at that location during Fiscal Year 1997. Report of Lynford E. Graham at 8 (Ex. 51); Mulherin Decl. ¶ 13. Thus, out of an abundance of caution, E&Y expanded its normal procedures and gave the Northern California district extra attention.

As plaintiffs note, IKON Northern California encountered difficulty using the SAP 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 6/30/97. 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 6/30/97. Mulherin Tr. 350 (Ex. 39); Mulherin Decl. ¶ 21; EY 562453-57 (Ex. 52).

First, the head of IKON's Internal Audit department, Daryle Yergler, visited the Northern California district and evaluated accounts receivable as of 8/31/97. EY 562482-94 (Ex. 52). Yergler tested the accuracy both of the recorded accounts receivable and of the corresponding reserve (EY 562482). He concluded that the Northern California district required a GAAP reserve of at least \$7 million to properly account for doubtful accounts receivable.

E&Y then reviewed and retested Yergler's procedures. Although it found Yergler's approach to be adequate, it concluded that there should be a larger cushion for potential bad debts. EY 562495-502 (Ex. 54); EY 562474-81 (Ex. 55). 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. EY 562481; EY 020186 (Ex. 56). 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. Mulherin Decl. ¶¶ 22-23; EYDF 006139; EY 562347-48 (Ex. 57); EY 562351-52 (Ex. 58).

Casting about for some dereliction or another, plaintiffs claim that E&Y's Northern California audit team "overrelied" on management's representations. Devor/Carmichael Report ¶¶ 49, 62(c). In particular, plaintiffs' experts opine that E&Y improperly relied on Yergler's audit work regarding accounts receivable. Even if true, such an allegation would hardly amount even to negligence, much less such extraordinary negligence as to be "close to intentional conduct." *Healey*, 616 F.2d at 649. But the claim of overreliance is in fact unsupported. Although E&Y did, to be sure, "review"

Yergler's work, the evidence unambiguously shows that E&Y retested the work prior to reaching its own conclusions. EY 562482.

Furthermore, it is hardly credible to assert that E&Y overrelied on IKON management's work when E&Y in fact disagreed with, and proposed additions to, Yergler's proposed reserve for doubtful accounts. And although plaintiffs' experts fault E&Y for not corroborating representations made by sales representatives at Northern California regarding the collectibility of accounts (Devor/Carmichael Report ¶49), these experts ignore — even though it is uncontested — that E&Y's substantial increase over Yergler's proposed allowance for doubtful accounts provided a significant cushion in the event some of the sales representatives had been too optimistic in estimating their chances of collecting old receivables.

Finally, plaintiffs' claims of "overreliance" also ignore the fact that reliance on management representations is an essential step in virtually any audit. In its representation letter relating to the 1997 audit, IKON management "recognize[d] that obtaining representations from us concerning the information contained in this letter is a significant procedure in enabling you to form an opinion whether the consolidated financial statements are presented fairly. . . ." IK0609122-27 (Ex. 59). For that reason, it is hardly surprising that the *McLean* court explicitly recognized that "inquiries of management," when used as one of several audit procedures (as used by E&Y here), "cannot be characterized as grounds so flimsy so as to lead to the conclusion that there was no genuine belief back of [the auditor's] representation." 599 F.2d at 1201.

3. Southern District

Plaintiffs also allege that the reserve for accounts receivable at IKON's Southern District was understated by approximately \$3.2 million as of 9/30/97. This claim — which is really just a small subset of plaintiffs' overarching disagreement with the adequacy of IKON's consolidated reserve for

doubtful accounts, previously discussed — rests entirely upon E&Y’s statement, in an interim report, that as of 6/30/97 and “according to IKON guidelines,” the Company needed to record \$3,684,000 in additional reserves. EY 525201 (Ex. 60).¹⁶ In other words, there was a question three months before year-end of whether this district was out of compliance with IKON policy.

E&Y therefore performed additional tests and analysis of the accounts receivable as of year-end, 9/30/97. E&Y concluded that the district should record an additional \$456,000 in bad debt allowance, thereby bringing the total allowance to \$1,368,000. EY 525117 (Ex. 62). Although E&Y recognized that IKON policy required a reserve of \$4,512,000, it determined that GAAP did not require such a high reserve, and instead concluded that \$1,368,00 was a conservative reserve. *Id.*

Nonetheless, plaintiffs fault E&Y for not booking the \$3.684 million that represented the amount by which the Southern District was out of compliance with IKON policy as of 6/30/97. According to their experts, E&Y allowed this shortfall “for no valid reason.” Devor/Carmichael Report ¶ 24(b). Again, however, plaintiffs’ experts’ views depend entirely on equating IKON policy with GAAP — an equation that plaintiffs’ experts stand virtually alone in defending. E&Y’s procedures went beyond the simple calculations required by IKON policy and involved instead analysis of the collectibility of individual accounts, the aging of accounts receivable, and other factors. McElderry Tr. 73-84. As was the case with Northern California, E&Y went significantly

¹⁶ Although the interim Summary Review Memorandum (“SRM”) states that “we proposed an adjustment to increase the company allowance for doubtful accounts by \$3,684 as of June 30, 1997 to ensure compliance with IKON Group Policy and GAAP” (EY 524888-91 at EY 524889) (Ex. 61), this statement was not intended to equate IKON policy with GAAP. To the contrary, John McElderry, who was responsible for the procedures performed to assess the adequacy of the reserve, testified that the \$3.684 million was a “policy” number. The sentence in the SRM, he said, meant only that compliance with policy would ensure that there was enough for GAAP purposes as well — and he made clear that policy in fact called for more reserves than GAAP. McElderry Tr. 24-25.

over budget in the Southern District, putting in almost 30 percent more hours than originally planned. Mulherin Decl. ¶ 24; EYDF 006140.¹⁷

4. IDS and IMS

Between February and May of 1997, IKON Document Services (IDS) and IKON Management Services (IMS) engaged in several intercompany transfers of assets in order to streamline each company's operations. As a result of this transfer of assets, there were several intercompany balances between the two companies that did not eliminate as of the time E&Y performed its audit procedures in 1997. In other words, IDS's records showed credits where IMS's records did not have a corresponding debit, and vice versa. Plaintiffs allege that E&Y did not perform the appropriate procedures to ensure that the intercompany balances between IDS and IMS properly reconciled. Specifically, plaintiffs cite two notations from the interim and final SRMs prepared by the E&Y office that performed procedures at IDS, which identify out-of-balance accounts at IDS and state that E&Y Philadelphia should ensure that intercompany accounts eliminate on a consolidated basis. Devor/Carmichael Report ¶¶ 32-33, 54(f), 62(a). Plaintiffs allege that E&Y failed to take additional audit steps suggested in these SRMs. *Id.*

Contrary to these assertions, the record shows, without exception, that E&Y did exactly what was suggested by its team performing the work at IDS — that is, E&Y ensured that intercompany accounts eliminated *on a consolidated basis*. Jim Mulherin testified that work was done during the 1997 audit to ensure that intercompany balances eliminated on a consolidated basis. Mulherin Tr.

¹⁷ Incredibly, plaintiffs also claim that E&Y failed to tailor its audit approach to take into account accounts receivable issues at Northern California and the Southern District (Devor/Carmichael Report ¶ 54(a)), and that E&Y did not expand its audit scope for “known problem areas” such as accounts receivable in Northern California. *Id.* ¶ 54(d). Yet, the record shows that E&Y did exactly that, going substantially over budget in each district in order to analyze the allowance for doubtful accounts. *See also* Mulherin Decl. ¶¶ 23-24.

458; Mulherin Decl. ¶ 26. And, with regard to IDS and IMS, Carmen Nepa testified that procedures were performed at year-end 1997 to ensure that those particular intercompany balances were eliminated. Nepa Tr. 593-604. Indeed, even plaintiffs’ own experts admit that reconciliation of intercompany accounts was an area of audit focus in 1997. Devor/Carmichael Report ¶ 30.¹⁸

5. Southern California

Plaintiffs also allege that E&Y failed to insist that IKON book certain *draft* findings from a compliance audit¹⁹ performed at IKON-Southern California in its consolidated financial statements for 1997. Devor/Carmichael Report ¶¶ 45-47. IKON-Southern California accounted for only 2.2% of IKON’s revenues and 0.7% of IKON’s assets. Plaintiffs allege that during this internal audit E&Y “identified at least \$7,041,000 of adjustments negatively impacting earnings.” Devor/Carmichael Report ¶ 45.

The document upon which they 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. EYDF 011420-25 (emphasis in original) (Ex. 64). While E&Y reviewed all finalized internal audit reports in connection with its post-audit procedures

¹⁸ Plaintiffs also complain that IDS did not have a reserve for \$3.6 million of receivables that it received from IMS that were aged greater than 180 days. Devor/Carmichael Report ¶ 24(c). This claim again appears based upon an unwarranted conflation of IKON policy and GAAP, overlooks a \$3 million excess reserve at IDS in 1997 (EY 020506-07) (Ex. 63), and ignores that, in addition to procedures performed at various IKON districts, E&Y also analyzed reserves on a consolidated basis. EY 035337-43; Mulherin Tr. 375-77; 385-88; 492-94; 500-01; Nepa Tr. 532-37. The review on a consolidated basis demonstrated that the consolidated reserves were adequate, even if (per plaintiffs’ 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.

¹⁹ A compliance audit is a review, through an internal audit function, of a business unit’s compliance with IKON policy.

for IKON's December 24, 1997 10-K filing (EY 021525) (Ex. 65), the evidence in the record clearly indicates that the Southern California internal audit was not completed during fiscal 1997 (EY 030872-873 (Ex. 66); EY 031003 (Ex. 67); EY 031046 (Ex. 68)), and that the draft internal audit report was not finalized prior to E&Y's release of its audit opinion on December 24, 1997. EY 050009 (Ex. 69); EY 320277-320281 (Ex. 70); Nepa Tr. 543. What is more, 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. EY 021525; Nepa Tr. 543-45, 558; Mulherin Decl. ¶ 28.

In fact, the vast bulk of the claimed \$7 million error that plaintiffs attribute to the draft internal audit report is an alleged \$4.2 million understatement of the lease default reserves at the Southern California marketplace. Devor/Carmichael Report ¶ 46. This amount is calculated without taking into account the value of the underlying copier equipment on all defaulted leases.²⁰ Plaintiffs appear to have acknowledged that they must take this value into account (see Dillon Tr. 64-66 (ex. 30); Giacobello Tr. 361 (Ex. 71); Slack Tr. 42 (Ex. 72)) in their decision to drop the bulk of their claims about IKON's consolidated lease default reserve; but inexplicably, they seem to take a different view with respect to this single district.²¹

²⁰ Plaintiffs 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.

²¹ There is no evidence in the record that E&Y acted recklessly in determining the adequacy of the lease default reserve on a consolidated basis. To the contrary, the record is replete

6. Failure to Record Certain Proposed Adjusting Entries

Plaintiffs 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. Devor/Carmichael Report ¶¶ 42-44. Plaintiffs' experts apparently admit that these adjustments need to be posted to the balance 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, the failure to post these adjustments results in a misstatement only if plaintiffs 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, plaintiffs are not correct with regard to either proposition, and accordingly are wrong as well with regard to the \$6 million in proposed adjusting entries.

7. Remaining Districts

Plaintiffs have a tendency to seize on a single piece of the 1997 IKON audit — a single district, sometimes (as in the case of Southern California), just a single marketplace *within* a single district — and imagine that the entire audit looks just like it. Of course, even the nits they pick disappear on closer reflection. But it is worth bearing in mind that plaintiffs have selected for criticism just a handful of the dozens districts or other entities that E&Y audited in 1997. To the remainder they pose no challenge, and surely that's not for want of trying.

What picture emerges of this massive audit when one reviews the record? One sees a company with \$5.12 billion in revenue comprising more than 100 operating entities. One sees a

with evidence that E&Y performed extensive procedures to evaluate the appropriateness of the reserve (Mulherin Tr. 149-51, 177-79; Nepa Tr. 550-53) and that IKON personnel confirmed the adequacy of the reserve. Slack Tr. 51-52. Moreover, plaintiffs' own expert admitted that he did not conclude that the lease default reserve was understated. Carmichael Tr. 173.

remarkably comprehensive audit by E&Y. With regard to the 1997 year-end audit, E&Y performed specific scope audits at eight locations (see Mulherin Decl. ¶ 12) accounting for \$1.97 billion — close to 40 percent — of IKON’s revenues. Graham Rpt., App. 3. Furthermore, E&Y performed full scope audits (see Mulherin Decl. ¶ 12) at locations accounting for an additional 10 percent of IKON’s revenue. Graham Rpt., App. 3. On top of these expansive procedures, IKON’s internal audit department, which was “outsourced” to E&Y, performed procedures at nearly 60 IKON locations. *Ibid.* Of course, E&Y considered internal audit’s findings in planning its audit and performing its procedures with regard to its audit of IKON’s 1997 financial statements. Mulherin Decl. ¶¶ 11, 28.

We doubt that plaintiffs have left many stones unturned in their effort to ferret out deficiencies in E&Y’s work. Thus, the fact that plaintiffs’ 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.

8. Plaintiffs’ Experts

Alone among all of the witnesses in the case, plaintiffs’ two accounting and auditing experts — and surely that’s one expert too many — will condemn the E&Y audit and assert that IKON’s 1997 financial statements were misstated. Toward that end, the experts, particularly Mr. Carmichael, have sprinkled their report and testimony with the usual expert hyperbole — “extreme departures” from this, and “extreme violations” of that. But testimony of this sort is precisely why the courts have cautioned against permitting cases to survive summary judgment simply on an expert’s say-so. As the United States Supreme Court has recognized, “[w]hen an expert opinion is not supported by sufficient facts to validate it in the eyes of the law, or when indisputable record facts contradict or otherwise render the opinion unreasonable, it cannot support a jury’s verdict.” *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 242 (1993).

In *Worlds of Wonder, supra*, for example, the Ninth Circuit applied that principle in a closely related setting. Plaintiffs contended that the trial court’s grant of summary judgment to the defendant auditing firm, Deloitte & Touche, was inappropriate because, in their expert’s opinion, Deloitte had acted with the requisite scienter. 35 F.3d at 1425. The Ninth Circuit rejected that argument, finding that the expert had made “an impermissible leap in logic to reach [his] conclusion.” *Ibid.* Similarly, in *Software Toolworks, supra*, the Court found that “[p]laintiffs’ expert’s conclusory statements” were not “sufficient to defeat summary judgment.” 789 F. Supp. at 1504 n.30 (agreeing with the defendant auditing firm that its evaluation of its client’s inventory reserve “was a matter of judgment on which Plaintiffs disagree, not a basis on which to infer scienter”). *See also Petrucelli v. Bohringer & Ratzinger*, No. CIV. A. 91-2098, 1994 WL 81999 (E.D. Pa. Mar. 10, 1994) (in granting defendant’s motion for summary judgment, noting that “[i]n order to defeat summary judgment, the party opposing the motion may not * * * substitut[e] conclusory allegations in a complaint with the conclusory allegations of an affidavit or even an expert report.”)

Plaintiffs’ accounting experts’ report suffers from just the type of defect recognized in these cases. Although the experts do not hesitate to characterize E&Y’s work as an “extreme departure” from professional standards, they never explain what in the record justifies such a conclusion. This is not surprising, as the record, in point of fact, reveals that Arthur Andersen — a prominent accounting firm that surely is aware of the applicable professional standards — concluded that it likely would have audited IKON’s 1997 financial statements in much the same way. On this record, it cannot seriously be contended — except, apparently, by someone who turns a blind eye to the evidence — that E&Y acted “recklessly.”

* * * *

Accordingly, the record unambiguously contravenes plaintiffs' quarrels with E&Y's audit. But plaintiffs' case against E&Y must clear an even higher hurdle. The statement alleged to be false and misleading — E&Y's opinion on IKON's 1997 consolidated financial statements — does not address any one account, or any one location. Instead, E&Y opined only on the consolidated statements of the company as a whole. Mulherin Decl. ¶ 32. Thus, even if plaintiffs could establish that E&Y's work with regard to one particular item, or one particular location, was deficient (which they cannot), plaintiffs still would not be able to establish that the E&Y audit — which addressed IKON's consolidated financial statements — was “so shoddy as to amount to a pretended audit.” Plaintiffs must establish that E&Y's decision to provide a “clean opinion” on IKON's consolidated financial statements, *as a whole*, was one that was not made honestly and did not reflect a genuine belief on E&Y's part that the consolidated financial statements were fairly presented. Without a doubt, the record clearly refutes any inference that the totality of E&Y's work was so deficient as to constitute “no audit at all.”

III. E&Y IS ENTITLED TO SUMMARY JUDGMENT AS TO THE CLAIMS OF ALL PLAINTIFFS WHO ALLEGE THAT THEY PURCHASED IKON STOCK IN RELIANCE UPON IKON'S OCTOBER 15, 1997 EARNINGS RELEASE

Rule 10b-5 requires a plaintiff to prove that the defendant made a “misstatement or omission of material fact.” *Semerenko*, 223 F.3d at 174.²² As discussed above, 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 publicly filed until December 24, 1997. Pursuant to plaintiffs' motion, this Court certified a class of all persons who purchased IKON stock beginning October 15,

²² On August 4, 1999, plaintiffs filed a second motion to amend the Complaint to assert a claim against E&Y under Section 11 of the Securities Act of 1933. Counsel for plaintiffs has recently agreed to stipulate to the dismissal of that claim with prejudice. Accordingly, the only claim that remains against E&Y is plaintiffs' 10b-5 claim.

1997, rather than December 24, 1997. In plaintiffs' view, E&Y may be held liable for any damages incurred by individuals who purchased stock in reliance on IKON's October 15, 1997 press release (Ex. 75) announcing the results of IKON's operations for fiscal year 1997 because E&Y allegedly "approved" the press release before IKON issued it.²³ That argument, however, is flatly inconsistent with the Supreme Court's holding in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), which abolished aiding-and-abetting liability under Rule 10b-5.²⁴ Accordingly, E&Y is entitled to summary judgment on all claims based on the October 15 press release — that is, all claims stemming from purchases before the public release of E&Y's opinion on December 24.

1. In *Central Bank*, the 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. 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 plaintiffs seek to bring here) based on their participation in the issuance of press releases and other unaudited public statements.

In *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), the Second Circuit affirmed the dismissal of a 10b-5 claim against E&Y that is conceptually indistinguishable from the claims

²³ See Plaintiffs' Motion for Revision of the Class Period Previously Certified as to Defendant Ernst & Young LLP ("Pl. Mem.") at 2, 5, 7 (Ex. 77).

²⁴ As the Court observed in its October 5, 2000 order certifying the class (Ex. 76), E&Y did not contest that "[t]he generic requirements for class certification are met." But E&Y did argue that, as a matter of law, individuals who purchased IKON stock prior to December 24, 1997 have no claim against E&Y. In granting plaintiffs' motion, the Court made clear that its certification of the class period was "without prejudice to the merits." Order at 1 n.1.

brought here by those who claim to have obtained IKON stock in reliance on IKON's October 15, 1997 earnings announcement. In that case, the plaintiffs 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).

Id. at 175 (quoting *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997)).²⁵

The two district courts in the Third Circuit to 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

²⁵ In so holding, the court explicitly rejected two earlier Second Circuit decisions relied upon by plaintiffs (Pl. Mem. 6) in this case. See *Wright*, 152 F.3d at 176 (disapproving, among others, *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450 (2d Cir. 1996), and *Azzielli v. Cohen Law Offices*, 21 F.3d 512 (2d Cir. 1994)). To the extent those cases might be read to allow for 10b-5 liability based on an actor's "substantial participat[ion]" in the issuance of a fraudulent misstatement, the theory has no application to claims of "fraud by accountants — secondary actors who may no longer be held primarily liable under § 10(b) for mere knowledge and assistance in the fraud." *Wright*, 152 F.3d at 176 (citing *Central Bank*, 511 U.S. at 177). Plaintiffs' attempt to distinguish *Wright* on its facts also fails. They claim that "in *Wright* there was no basis to claim that E&Y had endorsed the accuracy of the results." Pl. Mem. at 8 n.5. In fact, the *Wright* plaintiffs claimed that the company issued its press release "based on Ernst & Young's oral assurances." 152 F.3d at 172. And although the press release at issue in *Wright* noted that the reported results were unaudited, the basis of the Court's holding was that, because E&Y was not mentioned in the company's press release, "E&Y neither directly nor indirectly communicated misrepresentations to investors." *Id.* at 175.

corporate defendant's fraud. *Id.* at 1378. Finding 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.

2. Plaintiffs have urged the Court to reject the heavy weight of authority in favor of the far more sweeping standard articulated by a lone district court in the Northern District of Georgia. See *Carley Capital Group v. Deloitte & Touche, LLP*, 27 F. Supp. 2d 1324 (N.D. Ga. 1998) (Pl. Mem. at 8 n.5). In that case, the court held that there may be 10b-5 liability where the defendant “creates a misrepresentation, even if the misrepresentation is not publicly attributed to it.” *Id.* at 1334. But the holding in *Carley Capital* has been pointedly rejected by the only court in this Circuit to have addressed the decision because the Georgia case departs from the plain language of Section 10(b). See *Copland*, 88 F. Supp. 2d at 333 (rejecting *Carley Capital* because “this Court has adopted the Second Circuit's position [articulated in *Wright*], as it is consistent with the Supreme Court's holding in *Central Bank* and faithful to the statutory language of § 10(b).”). The *Carley Capital* standard also is inconsistent with the holding in *Central Bank* that a secondary actor may be liable under Section

10(b) only where a plaintiff can establish reliance on that actor's own representations. Where no representation can be attributed to the secondary actor, no reliance can be shown, and no liability should attach. See *Wright*, 52 F.3d at 175 (liability for a statement not attributed to the defendant would circumvent the statute's reliance requirement); see also *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 n.10 (10th Cir. 1996) (noting that cases allowing liability to attach without a representation being made by the defendant do not comport with *Central Bank*).

In any event, even under the *Carley Capital* standard, E&Y cannot be held liable for any misrepresentation contained in IKON's October 15, 1997 press release. Plaintiffs' argument is that E&Y provided its "approval and agreement" to IKON before IKON issued the press release. See Pl. Mem. at 2 n.1 (quoting deposition testimony of IKON CFO Kurt Dinkelacker). That is a far cry from the allegation in *Carley Capital* that the auditor "specifically directed" the company's action, which was considered tantamount to the auditor's own "creation" of the misstatement. *Carley Capital*, 27 F. Supp. 2d at 1334. There is *no* evidence in this case that E&Y authored 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 Guinan Tr. 205

(Ex. 78).²⁶ E&Y’s “approval” of the press release plainly fails to satisfy even the *Carley Capital* “creation” test.²⁷

Because E&Y cannot be liable for any misstatement contained in IKON’s October 15, 1997 press release, the Court should enter summary judgment with respect to all claims based upon the acquisition of IKON stock prior to December 24, 1997, the date on which E&Y’s audit report was issued.

²⁶ Ms. Guinan testified as follows:

Q: Were the final decisions on the wording of press releases the decisions of IKON, as opposed to Ernst & Young?

A: Yes, I believe they were — they should be considered IKON’s. Everyone would give their own comments as to wording, and they would be accumulated and then finalized. So, I would not consider them to be Ernst & Young’s words. I would consider them to be IKON’s words.

²⁷ For the same reason, E&Y could not be liable for statements contained in the October 15, 1997 press release even under the very broad “substantial participation” standard applied in a number of the cases cited (but not endorsed) by plaintiffs here. E&Y’s limited role in reviewing the text of IKON’s press release cannot reasonably be construed as “substantial.” In contrast, in *In re Software Toolworks, Inc.*, 50 F.3d 615, 628-29 (9th Cir. 1994) (Pl. Mem. at 6-7), the accounting firm was mentioned by name in a letter to the SEC containing the alleged misrepresentations, and the SEC was directed to contact the accounting firm for further information. Here, of course, E&Y was not even mentioned in IKON’s press release. And in *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 433 (N.D. Ill. 1995) (Pl. Mem. at 7), the plaintiffs alleged that the auditors had “masterminded” the public statements. Here, plaintiffs allege only that IKON waited until after E&Y had read the press release before issuing it — an allegation that would potentially extend liability to every public accounting firm for the press releases of its client. Finally, in *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (Pl. Mem. at 7), the plaintiffs alleged that the accounting firm was “intricately involved” in the alleged misstatements, and the court, in reaching its conclusion, did not even cite *Central Bank*.

CONCLUSION

For the foregoing reasons, the Court should enter summary judgment in favor of E&Y on plaintiffs' claims. In the alternative, the Court should enter summary judgment with respect to all claims arising prior to December 24, 1997.

Respectfully submitted,

Edward M. Posner
Pa. Bar No. 19363
DRINKER BIDDLE & REATH LLP
One Logan Square
18th and Cherry Streets
Philadelphia, PA 19103-6996
(215) 988-2700

Lawrence S. Robbins
Gary A. Orseck
MAYER, BROWN & PLATT
1909 K Street, NW
Washington, DC 20006
(202) 263-3000

Patricia A. McGovern
ERNST & YOUNG LLP
787 Seventh Avenue
New York, NY 10019
(212) 773-3000

Attorneys for Ernst & Young LLP

Dated: October 16, 2000