UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
TAMPA DIVISION

IN RE:

TRITON NETWORK SYSTEMS, INC. SECURITIES LITIGATION ______________________________/

Case No. 8:02-CV-1041-T-27MAP

(Dispositive Motion)

MEMORANDUM OF LAW IN SUPPORT OF DEFENDANT ERNST & YOUNG LLP'S MOTION TO DISMISS CONSOLIDATED AMENDED CLASS ACTION COMPLAINT

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INTRODUCTION

Pursuant to Fed. R. Civ. P. 12(b)(6), defendant Ernst & Young LLP ("E&Y") submits this memorandum in support of its motion to dismiss the Consolidated Amended Class Action Complaint ("Am. Cplt.") in this case. As we show below, the Amended Complaint, despite its proliferation of grievances against the now-defunct Triton Network Systems, Inc. ("Triton"), has next to nothing to say about E&Y, and what little it says is legally insufficient. For multiple and independently sufficient reasons, the Amended Complaint should be dismissed with prejudice.

In the main, the Amended Complaint tells the familiar story of an investment in a high-tech venture that was known to be risky at the outset and which cratered in the wake of the market's collapse. Plaintiffs purport to sue on behalf of all persons who purchased Triton stock between July 13, 2000 and August 20, 2001. Am. Cplt. ¶ 29. Founded in 1997, Triton manufactured high-speed wireless equipment for telecommunications providers. *Id*. ¶¶ 59, 1. In July 2000, Triton completed its initial public offering ("IPO"), through which it sold 6.325 million shares of common stock at $15.00 per share. *Id*. ¶ 2. In connection with the IPO, the company filed a prospectus (the "Prospectus"). *Ibid*.

The Prospectus plainly disclosed significant risks related to Triton's financial results. It explained that because the company recognized its very first revenues in the three-month period ending March 31, 2000, a potential investor might have difficulty evaluating Triton's business. See Joint Appendix In Support of Defendants' Motions to Dismiss, Ex. A at 7. It warned that Triton might *never* achieve profitability if its products failed to achieve market acceptance. *Id*. at 9. And it disclosed that Triton relied on three "key customers" – Advance Radio Telecom ("ART"), CenturyTel, and CAVU – for "substantially all" of its sales, and added that the loss of any one of these customers could "significantly reduce revenues." *Ibid*.

Just as Triton had warned, two of the company's customers (like much of the relevant market) thereafter encountered financial difficulties. On November 14, 2000, Triton issued a press release stating that ART had postponed product deliveries until 2001 so that ART could obtain "additional financing." Am. Cplt. ¶ 150. In March 2001 Triton announced that ART would file for bankruptcy, which ART did a month later. Jt. App. Ex. C; see also Am. Cplt. ¶ 71. On December 4, 2001, CAVU announced that it too had filed for bankruptcy. *Id*. ¶ 72.

Triton's stock price declined over the entire class period. On August 20, 2001, the last day of the class period, Triton announced that its directors had voted to liquidate the company. *Id*. ¶ 25. The day before this announcement was made, Triton's stock was trading at 44 cents a share. See Jt. App. Ex. D. After the announcement, however, the stock price rose to 65 cents a share. See *id*.; see also Am. Cplt. ¶ 27.

Plaintiffs thereafter brought suit on June 11, 2002 (see D.E. 1), and filed the present Amended Complaint on November 12, 2002, asserting claims against certain officers and directors of Triton, Oak Investment Partners (an alleged "control person" of Triton), the underwriters of Triton's IPO, and E&Y, Triton's auditor. As to E&Y, Count I asserts a claim under Section 11 of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77k, and Count III asserts a claim under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5.[1] The Section 11 claim asserts that E&Y's audit opinion on the company's 1999 financial statements – which opinion was incorporated in the Prospectus – was false because the financial statements themselves were misstated. Am. Cplt. ¶¶ 41, 94. The Section 10(b) claim challenges E&Y's audit opinions on

[1] Counts I and III are also asserted against the other defendants. E&Y is not named in Count II (Section 15 of the Securities Act) or Count IV (Section 20(a) of the Exchange Act).

Triton's financial statements for both the fiscal years ending December 31, 1999 and December 31, 2000. *Id*. ¶¶ 229, 245.

Plaintiffs' claims against E&Y are fundamentally flawed, and for multiple reasons. First, although plaintiffs lodge a series of complaints about the Prospectus, almost none of them even *relates* to the 1999 financial statements (the only portion of the Prospectus that E&Y certified, and thus the only portion on which it can conceivably be held liable under Section 11); and what little relates to the financial statements is legally insufficient to state a claim. The Section 10(b) claim fails as well, because its boilerplate allegations of scienter fall far short of the heightened pleading standard set by the Private Securities Litigation Reform Act ("PSLRA" or "Reform Act"), 15 U.S.C. § 78u-4(b). Moreover, both claims against E&Y must be dismissed because, under *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441 (11th Cir. 1997), the facts alleged in the Amended Complaint conclusively show that plaintiffs' losses were not caused by any misrepresentation alleged to have been made by E&Y. And if these reasons were not enough, plaintiffs' claims are also barred by the statute of limitations (as is explained more fully in the motion to dismiss filed by the individual defendants, which we hereby adopt by reference).[2]

ARGUMENT

A motion to dismiss may be granted where "it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." *Blackston v. State of Alabama*, 30 F.3d 117, 120 (11th Cir. 1994) (internal quotation omitted). Furthermore, the PSLRA established "heightened pleadings requirements" for securities actions such as this one. "If these additional requirements are not met, the Court *must* dismiss the action. *Cheney v.*

[2] E&Y further adopts by reference all of the arguments presented by the Individual Defendants and the Underwriter Defendants in their Motions to Dismiss.

Cyberguard Corp., No. 98-6879-CIV-GOLD, 2000 WL 1140306, *4 (S.D. Fla. July 21, 2000) (citing 15 U.S.C. § 78u-4(b)(3)) (emphasis added).

In assessing the sufficiency of a complaint under Rule 12(b)(6), the Court may consider "the face of the complaint" (*Brooks v. Blue Cross & Blue Shield of Fla., Inc.*, 116 F.3d 1364, 1368 (11th Cir. 1997)), as well as other matters of public record. *Watson v. Bally Mfg. Corp.*, 844 F. Supp. 1533, 1535 n.1 (S.D. Fla. 1993), *aff'd*, 84 F.3d 438 (11th Cir. 1996). Additionally, "the district court may take judicial notice of well-publicized stock prices." *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 166 n.8 (2d Cir. 2000). The Court also may consider documents required to be filed with the Securities and Exchange Commission on a motion to dismiss. *Bryant v. Avado Brands*, 187 F.3d 1271, 1277-78 (11th Cir. 1997).

I. PLAINTIFFS' SECTION 11 CLAIM SHOULD BE DISMISSED BECAUSE PLAINTIFFS HAVE NOT ALLEGED A MATERIAL MISSTATEMENT IN THE PORTION OF THE PROSPECTUS CERTIFIED BY E&Y

Section 11 provides a cause of action to purchasers of securities where "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact. . . ." 15 U.S.C. § 77k(a). In order to state a claim under Section 11, a plaintiff must allege a material misstatement or omission in the Prospectus (which is part of the "registration statement"). *Ehlert v. Singer*, 245 F.3d 1313, 1316 (11th Cir. 2001). An auditor, however, may be held liable under Section 11 only for those portions of the registration statement that it prepared or certified. 15 U.S.C. § 77k(a)(4) (specifying that investor may sue auditor only "with respect to the statement in such registration statement . . . which purports to have been . . . certified by him"). And that is a crucial limitation: E&Y had absolutely no role in preparing or certifying the vast bulk of the Prospectus – pages 1 through 71 – which contain a discussion of the company, its business plans, the use of proceeds from the IPO, and the risk factors associated

with investing. Only the second portion of the Prospectus (pages F-1 through F-20) – which contains the company's financial statements – was subject to E&Y's certification, and even then it is *only* the 1999 year-end financial statements, not the first quarter of 2000 financial statements, that were the subject of E&Y's opinion.

So the question under Section 11, as far as E&Y is concerned, is whether the Amended Complaint sufficiently alleges falsity *in the 1999 financial statements*. And glittering generalities simply will not do. As this Circuit has explained in affirming the dismissal of a Section 11 claim, "conclusory allegations, unwarranted deductions of facts or legal conclusions masquerading as facts will not prevent dismissal." *Oxford Asset Mgmt., Ltd. v. Jaharis*, 297 F.3d 1182, 1188 (11th Cir. 2002). As we next show, most of the grievances advanced by plaintiffs do not even relate to the 1999 financial statements, and those that do flunk the "conclusory allegations" test. At least as to E&Y, then, the Section 11 claim must be dismissed.

A. The Effectiveness of Triton's Product

Plaintiffs allege that Triton's product was defective (see Am. Cplt. ¶¶ 15-16, 21-22, 48-56), and that, as a result, Triton (i) overstated its revenues in the first quarter of 2000 by recording revenue for defective products that had been returned (*id.* ¶¶ 21, 60-61), and (ii) overvalued its inventory by valuing its substandard products at retail price (*id.* ¶ 22). Neither of these alleged errors, however, relates to the 1999 year-end financial statements – indeed, none of them could *possibly* relate to the 1999 financial statements since, as both the Prospectus and the Amended Complaint make clear, Triton *did not recognize any revenue in fiscal year 1999*. See Ex. A at F-4 (no revenues listed for fiscal year 1999); Am. Cplt. ¶ 59 (company recognized its first revenue in the first quarter of 2000). Because the audited financial statements reported *no*

revenue for fiscal year 1999, they could not possibly have overstated the company's revenue.[3] At bottom, plaintiffs' allegations regarding revenue recognition are based on the financial results for the first quarter *of 2000* (Am. Cplt. ¶ 60); but those quarterly statements were not audited (see Ex. A at F-4), and plaintiffs do not allege that E&Y certified those results.

Nor do plaintiffs allege that Triton's inventory (which purportedly valued Triton's product at its retail price) was overstated in 1999. Plaintiffs claim only that a charge should have been taken for overvalued inventory *in 2000*. Am. Cplt. ¶¶ 252-53. Again, because the audit opinion incorporated into the Prospectus did not pertain to Triton's results for any part of fiscal year 2000, the Amended Complaint does not allege a misstatement on the part of E&Y with regard to the claim that Triton's product was defective.

B. The Ability of Triton's Customers to Pay

Plaintiffs next allege that the Prospectus was misleading in that it touted Triton's supply agreements with ART and CAVU. According to plaintiffs, the Prospectus professed that the company would earn material amounts of revenue from ART and CAVU in 2000 and 2001. Am. Cplt. ¶¶ 66-68. This representation is said to be misleading, because, according to plaintiffs, these two customers allegedly lacked the financial resources to honor their purchase commitments to Triton. *Id.* ¶ 75.

Again, however, these allegations have nothing to do with the 1999 financial statements – the only ones in the Prospectus that were audited by E&Y. Plaintiffs allege only that the

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[3] Even as to fiscal year 2000, the claim that Triton's products were so defective that customers would not pay for the product (see Am. Cplt. ¶ 21) appears to be contradicted by Triton's reported financial results. For fiscal year 2000, Triton reported $26.2 million in revenue. See Jt. App. Ex. B (Triton's 10-K for fiscal year 2000) at F-4. For the same time period, the company reported only $4.8 million in accounts receivable. *Id.* at F-3. If the company had only $4.8 million in outstanding receivables at the end of the year, the company must have collected the remaining portion – $21.4 million, or approximately 81% – of the amount that it billed.

Prospectus projected revenue for fiscal years 2000 and 2001, but do not allege any role of E&Y in formulating these projections. They do not allege that Triton reported any revenue from these contracts in 1999, nor do they allege that ART's and CAVU's potential insolvency had any impact on Triton's 1999 financial statements. Accordingly, with regard to this issue, plaintiffs have likewise failed to allege a misstatement in the portion of the Prospectus certified by E&Y.

C. Valuation of Assets Purchased From IBM

Plaintiffs next allege that the Prospectus overstated the value of certain assets that Triton purchased from IBM on March 31, 2000. (Although the company's fiscal year end was December 31, the 2000 purchase from IBM was incorporated as a "subsequent event" in the 1999 financial statements (see Ex. A at F-19) and was separately audited and opined on by E&Y (*id*. at F-2)). According to the Prospectus, the purchase price "was based on the fair value of the series C preferred stock using the Company's initial public offering price of $15.00 per share." Ex. A at F-19; see also Am. Cplt. ¶ 78 (quoting Prospectus).[4] As plaintiffs see it, Triton should have valued the assets at a price of $10 per share, which was the price at which Triton stock had sold *five months before* the IBM asset purchase. Am. Cplt. ¶ 80. As evidence of the alleged overvaluation of the assets, plaintiffs emphasize that in March 2002 (two years later) Triton sold its broadband modem operation, including the IBM assets, for $103,000. *Id*. ¶ 81.

It is hard to see how the statement in the Prospectus about the value of the IBM assets was "untrue" for Section 11 purposes. After all, the Prospectus clearly disclosed that Triton purchased the IBM assets with Series C preferred stock valued at the price set at the time of the IPO – $15 a share. The Prospectus *also* disclosed that in October and November of 1999, the

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[4] The stock used to purchase the IBM assets was Series C preferred stock. Upon completion of the IPO, all preferred stock was converted to common stock. See Ex. B at F-14.

company had sold some Series C preferred stock at $10 per share. Am. Cplt. ¶ 80. Thus, potential investors were given complete information with which to evaluate the IBM assets – and plaintiffs do not contend that any of this information is actually *false*.

Instead of identifying a false statement, plaintiffs argue that Triton should have chosen the October 1999 stock price instead of the July 2000 stock price in valuing the IBM assets purchased in March 2000. But even if such a quarrel could give rise to a finding of falsity, plaintiffs offer no reason why their proffered valuation is better than the one chosen by the company. (Indeed, Triton selected a stock price closer in time to the actual transaction). As for plaintiffs' allegation that the IBM assets (along with other assets *and liabilities* (see Jt. App. Ex. E at 8)) were sold two years after their purchase for $103,000, that truly is a red herring. As plaintiffs readily concede, "[t]he fair value of an asset is the amount for which it can be bought or sold in a current transaction between willing parties; that is, *other than through a forced or liquidation sale*." Am. Cplt. ¶ 82 (emphasis added). But the company sold its broadband modem operation (including the IBM assets) six months after it made the decision to liquidate. *Id*. ¶¶ 81 (assets sold for $103,000 in March 2002), 25 (company announced liquidation in August 2001). Thus, Triton sold the IBM assets in liquidation – *precisely* the circumstances that plaintiffs readily admit can *never* be appropriate for valuation purposes.

The bottom line, however, is this: Even if plaintiffs' chosen price were more appropriate, that would not render the Prospectus *false*. Triton provided full disclosure of the different stock prices over time and stated – plainly and truthfully – that it had selected the price as of July 2000.

D. Disclosure of Details Concerning Related Parties

Finally, the Amended Complaint alleges that the Prospectus did not fully disclose the connections between Triton and certain "related parties." In particular, plaintiffs focus on Brian

Andrew, one of Triton's founders. *As the Prospectus fully discloses*, Mr. Andrew left Triton to become the Chief Executive Officer of CAVU, although he continued to sit on Triton's Board of Directors until the end of the first quarter of 2000. Am. Cplt. ¶ 86; Ex. A at 50. Plaintiffs appear to believe that, because of the dual roles of Mr. Andrew, Triton and CAVU must be considered related parties.

That allegation is doubly flawed, however. First, merely by having an officer or director in common does not make two companies "related" for disclosure purposes. See Am. Cplt. ¶ 85 (describing basis for finding two parties "related"). Second, and in any event, plaintiffs do not allege a single transaction with CAVU that the company failed to disclose in its 1999 financial statements. Indeed, the Prospectus states (and plaintiffs themselves concede in the Amended Complaint) that Triton entered into its first purchase contract with CAVU in the second quarter of 2000 (when Mr. Andrew was no longer a director of Triton). Am. Cplt. ¶ 68. Thus, even if CAVU and Triton were related parties under the relevant accounting standards, plaintiffs have not alleged that the Prospectus contained any material misstatements or omissions regarding transactions between CAVU and Triton.[5]

Accordingly, the Amended Complaint does not allege any misstatement in the portion of the Prospectus certified by E&Y. Plaintiffs' Section 11 claim should be dismissed.

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[5] The Amended Complaint does contain some discussion of the relationship of Triton and ART, although it does not specifically allege that the Prospectus is misleading in this regard. Am. Cplt. ¶¶ 88, 102-03, 248. The companies shared one director, Bandel L. Carano, and (as discussed above) Triton entered into a sales agreement with ART in 1999. The Prospectus, however, clearly discloses under the heading "Certain Relationships and Related Transactions" that Triton entered into a supply Agreement with ART in December 1999, and that Mr. Carano was a director of both Triton and ART. Ex. A at 56-57.

II. PLAINTIFFS' CLAIM AGAINST E&Y UNDER SECTION 10(B) SHOULD BE DISMISSED BECAUSE THE COMPLAINT DOES NOT ADEQUATELY ALLEGE THAT E&Y ACTED WITH SCIENTER

In order to allege a claim under Section 10(b), a complaint must allege: (1) a misstatement or omission, (2) of a material fact, (3) made with scienter, (4) on which plaintiff relied, (5) that proximately caused plaintiff's injury. *Bryant*, 187 at 1281. In order for a secondary actor such as an auditor or an attorney to be held liable, "the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff's investment decision was made." *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (citing *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998)). Plaintiffs allege only two statements that were publicly attributable to E&Y: E&Y's audit opinion on Triton's 1999 year-end financial statements and E&Y's audit opinion on Triton's 2000 year-end financial statements. Am. Cplt. ¶ 5. Thus, those are the only two statements for which E&Y could be held liable.

Plaintiffs allege that E&Y's audit opinions on the 1999 and 2000 financial statements were false and misleading because those financial statements did not comply with Generally Accepted Accounting Principles ("GAAP") and because E&Y's audit was not performed in accordance with Generally Accepted Auditing Standards ("GAAS"). Am. Cplt. ¶¶ 230, 253. With regard to the 1999 financial statements, we have established (see Section I, *supra*) that plaintiffs have not sufficiently alleged that those financial statements were false or misleading. With regard to the 2000 financial statements, plaintiffs repeat the same claims of wrongdoing and add one more allegedly misleading practice: that the company engaged in "bill and hold" sales, billing for and recording revenue for sales in the fourth quarter of 2000 but holding the product over for shipment until the first quarter of 2001. Am. Cplt. ¶¶ 17-18, 288. We do not

concede that there are, in fact, any material misstatements or omissions in Triton's 2000 financial statements. Nonetheless, wholly apart from the alleged falsity of the 1999 and 2000 financial statements, plaintiffs' Section 10(b) claim against E&Y should be dismissed because of a wholesale failure to allege scienter.

"[T]he term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Short of proving actual intent to harm, only "'severe recklessness' satisfies the scienter requirement." *Bryant*, 187 F.3d at 1282. "Severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814 (11th Cir. 1989) (internal quotation omitted). What is more, "[t]he Reform Act augmented the Rule 9(b) standard. . . ." *In re Sunstar Sec. Healthcare Litig.*, 173 F. Supp. 2d 1315, 1318 (M.D. Fla. 2001). The PSLRA "expressly requires plaintiffs to 'state *with particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind.'" *Bryant*, 187 F.3d at 1282 (quoting 15 U.S.C. § 78u-4(b)(2)) (emphasis added by court). A complaint must make "fact-specific allegations of recklessness." *Bryant*, 187 F.3d at 1283.

The Amended Complaint, however, is starkly lacking in specific factual allegations as to E&Y. Although it includes page upon page of quotations purportedly from former employees discussing problems with the company (see, *e.g.*, ¶¶ 49-56, 60, 64, 156-57, 165, 184-88) and with its directors and officers (*id*. ¶¶ 104-08), there is not the slightest suggestion that any of these alleged deficiencies were disclosed to E&Y. Bereft of "*particular[]* facts giving rise to a

strong inference of scienter" (*Bryant*, 187 F.3d at 1282), plaintiffs instead marshal the usual litany of boilerplate allegations: (i) that E&Y charged fees for its services to Triton (Am. Cplt. ¶¶ 274); (ii) that E&Y had access to the company's books and records (*id*. ¶ 280); (iii) that Triton made "staggering" write-offs to its inventory and intangible assets after the 2000 Form 10-K was released (*id*. ¶ 279); and (iv) that E&Y violated a list of GAAS principles. Mindful that in this Circuit a plaintiff must plead "red flags" alerting an auditor to the possibility of fraud (see, *e.g.*, *Ziemba*, 256 F.3d at 1209), plaintiffs include a section in the Amended Complaint entitled "Red Flags." This Section, however, includes absolutely no specific *factual* allegations regarding E&Y. Instead, it contains well-traveled and conclusory allegations that E&Y knew or should have known of the alleged problems with Triton's financial reporting. *Id*. ¶¶ 284-91.

But district courts in this Circuit do not tolerate such threadbare allegations against auditors. See *In re Sunterra Corp. Sec. Litig.*, 199 F. Supp. 2d 1308 (M.D. Fla. 2002); *Holmes v. Baker*, 166 F. Supp. 2d 1362 (S.D. Fla. 2001); *Cheney v. Cyberguard Corp.*, *supra*, 2000 WL 1140306 at *4. In each of these cases, as in the present case, the plaintiffs alleged that the auditor had failed to follow GAAS and that the financial statements did not comply with GAAP. *Sunterra*, 199 F. Supp. 2d at 1333; *Holmes*, 166 F. Supp. 2d at 1375; *Cyberguard*, 2000 WL 1140306 at *10; Compare Am. Cplt. ¶ 230. In each of these cases, as here, plaintiffs alleged that the company had engaged in "improper practices" – including inappropriately recognizing revenue – and that the auditor would have caught the dereliction if only it had complied with GAAS. *Sunterra*, 199 F. Supp. 2d at 1334 (prematurely recognizing revenue); *Holmes*, 166 F. Supp. 2d at 1379 (alleging "bill and hold" transactions and overstatement of inventory); *Cyberguard*, 2000 WL 1140306 at *10 (prematurely recognizing revenue); Compare Am. Cplt. ¶¶ 248, 252, 257, 262. In all three cases, the plaintiffs emphasized the large "magnitude" of the alleged

financial errors. *Sunterra*, 199 F. Supp. 2d at 1333; *Holmes*, 166 F. Supp. 2d at 1379; *Cyberguard*, 2000 WL 1140306 at *11, 12; Compare Am. Cplt. ¶ 279. And in *Sunterra*, as here, the plaintiffs alleged that the auditor enjoyed regular access to the company's books and records. 199 F. Supp. 2d at 1338; Compare Am. Cplt. ¶ 280. Yet, in each and every one of these cases, the courts held that the allegations failed to plead scienter.

And the similarities don't end there. Each of these three courts emphasized that violations of GAAP and GAAS alone do not give rise to an inference of scienter. *Sunterra*, 199 F. Supp. 2d at 1336; *Holmes*, 166 F. Supp. 2d at 1380; *Cyberguard*, 2000 WL 1140306 at *11. Nor did the courts blindly accept allegations labeled as "red flags." "Plaintiff's red flags consist primarily of rehashes of the GAAP violations. . . ." *Holmes*, 166 F. Supp. 2d at 1379; see also *Sunterra*, 199 F. Supp. 2d at 1337 (quoting *Holmes*). "[T]he flaw in these allegations is that a plaintiff cannot plead scienter by merely alleging that later disclosed information 'would have been' discovered earlier if the auditor had not violated GAAS. Not only does this type of pleading constitute fraud by hindsight, but it establishes nothing more than ordinary negligence." *Cyberguard*, 2000 WL 1140306 at *12; see also *Ziemba*, 256 F.3d at 1210 ("Plaintiffs' purported 'red flags' consist of the [auditor's] possession of documents and other information which Plaintiffs allege should have revealed the need for going concern qualifications . . . . At most, these allegations raise an inference of gross negligence, but not fraud."). The *Sunterra* court reached this conclusion notwithstanding the auditor's regular access to the company's books and records. 199 F. Supp. 2d at 1338.

Nor were these courts swayed by plaintiffs' allegations regarding the size of the company's later restatements of their financial statements. "[T]he magnitude of the restatement does not, without evidence that the auditor was aware of the falsity of the original statements, raise an

inference of scienter." *Cyberguard*, 2000 WL 1140306 at *12. See also *Sunterra*, 199 F. Supp. 2d at 1338 (magnitude of restatement "does not necessarily reflect the magnitude of what [the auditor] could have observed in conducting its audit. . . .").[6] And, finally, plaintiffs cannot survive dismissal simply by alleging that E&Y collected audit fees. As the Ninth Circuit held, in affirming a finding that the defendant auditors had not acted with scienter: "'It is highly improbable that an accountant would risk surrendering a valuable reputation for honesty and careful work by participating in a fraud merely to obtain increased fees.'" *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1427 n.7 (9th Cir. 1994) (quoting *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1242 n.60 (S.D.N.Y. 1992)).[7]

III. ANY ALLEGED MISREPRESENTATIONS BY E&Y WERE NOT THE CAUSE OF PLAINTIFFS' LOSSES

Under Section 10(b), a plaintiff must prove that a defendant's misrepresentations were the proximate cause of the plaintiff's losses. *Bryant*, 187 F.3d at 1281. This requirement is also known as "loss causation." *Robbins v. Koger Properties, Inc.*, *supra*. Under Section 11, a plaintiff generally may recover damages representing the difference between what was paid for

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[6] With regard to the size of the alleged errors, plaintiffs' allegations in the present case are even weaker than those rejected in *Cyberguard*. In that case, the company restated its previously reported financial results, thereby admitting an error in its financial statements. Here, on the other hand, Triton has never admitted error in its financial reporting. Instead, plaintiffs take issue with charges to inventory and intangible assets. Charges do *not* constitute an admission that those items were improperly recorded in a prior period; they reflect nothing more than the fact that recent events require the revaluation of assets. See, *e.g.*, Am. Cplt. ¶ 207 (company writing down value of inventory in based on ART's filing for bankruptcy).

[7] The decision in *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326 (S.D. Fla. 1999), is sharply distinguishable since, as the courts in *Sunterra*, *Holmes*, and *Cyberguard* pointed out, the complaint in *Sunbeam* alleged that an employee had explicitly "tipped off" the auditor to the fraud by the client. See, *e.g.*, *Sunterra*, 199 F. Supp. 2d at 1336-37. *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324 (N.D. Ga. 1998), is also distinguishable. There, the defendant was "heavily involved in management." *Id*. at 1339. Here, there is no allegation that E&Y served in a remotely comparable role at Triton.

the security and its value at the time the suit was brought or what it was sold for before the suit was brought. 15 U.S.C. § 77k(e). Nonetheless, where a plaintiff's damages are not caused by the alleged misrepresentation, a Section 11 claim will fail as a matter of law. *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 340 (2d Cir. 1987) (affirming summary judgment for defendants where defendants established that the company's stock price decline was caused by factors other than those misstated in registration statement). The standards for establishing causation (other than the burden of proof) are identical under Section 10(b) and Section 11. See, *e.g.*, *In re Worlds of Wonder*, 35 F.3d at 1422 (applying Section 10(b) cases to analysis of Section 11(e) defense).

Robbins v. Koger sets forth the standard for loss causation in the Eleventh Circuit. In *Koger*, the stock of the defendant company, Koger Properties, declined during the class period, falling precipitously after Standard and Poor's downgraded the company's credit rating and the company drastically reduced its quarterly dividend. 116 F.3d at 1445. Some time after these events, "it was discovered that the [company's] audited financial statements were false." *Ibid*. Following the public announcement of this discovery – the so-called "corrective disclosure" – Koger took a charge of $100 million to its balance sheet. The shareholder plaintiffs brought a Section 10(b) claim against the company's auditors, Deloitte & Touche, alleging that they had "suffered damage when they purchased [Koger] stock . . . because the price of the stock was 'artificially inflated'" as a result of Deloitte's clean audit opinions on the incorrect financial statements. *Ibid*. The trial court held that plaintiffs' allegations of artificial inflation were sufficient to establish loss causation *Id*. at 1446.

The Eleventh Circuit reversed. The Court began by noting that to establish loss causation, plaintiffs must show that the alleged misrepresentation "was in some reasonably direct, or

proximate, way responsible for [the] loss." *Id*. at 1447 (quoting *Huddleston v. Herman & MacLean*, 640 F.2d 534, 548 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983). Thus, even "'[i]f the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule [10b-5] is not permitted.'" *Robbins*, 116 F.3d at 1447 (quoting *Huddleston*, 640 F.2d at 549).

In the case before it, the Court of Appeal observed, it was possible "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 1447-48. The Court noted that the price of stock dropped throughout the class period, that is, *before* it was revealed that Deloitte's clean audit opinions were false. *Id*. at 1448. Thus, plaintiffs did not establish "a connection between Deloitte's misrepresentations and the decline in price of [Koger's] stock throughout the class period. . . . Instead, plaintiffs simply claim that they paid too much." *Ibid*.

For precisely the reasons articulated by the Eleventh Circuit in *Robbins*, the Amended Complaint forecloses a finding of loss causation as a matter of law. Under a Section labeled "THE TRUTH EMERGES," the Amended Complaint alleges that on August 20, 2001 the Company announced that the Board of Directors had voted to liquidate and dissolve the company. Am. Cplt. ¶ 217. This press release, then, is what plaintiffs allege to be the "corrective disclosure." But, as the Amended Complaint candidly concedes, by the time the company announced its liquidation, Triton stock had already "*lost virtually all of its value*, closing at $.65 per share on August 20, 2001." *Id*. ¶ 27 (emphasis added). Indeed, the day *before* the com-

pany's announcement, the stock was trading at 44 cents a share; its price *rose* after the announcement to close at 65 cents. See Ex. D.[8]

In short, as was the case in *Robbins*, the decline in value of Triton's stock occurred *before* the "corrective disclosure." There was no decline in price after the supposed revelation of the falsity of the company's financial statement. Accordingly, even if E&Y's clean audit opinions were false – as Deloitte's audit opinions were alleged to be in *Robbins* – those misrepresentations could not be the proximate cause of plaintiffs' losses. See also, *Akerman*, 810 F.2d at 342 ("The price decline before disclosure may not be charged to defendants.").[9] Because the facts as alleged in the Amended Complaint establish, as a matter of law, that E&Y's audit opinions did not cause plaintiffs' losses, both the Section 10(b) and the Section 11 claims must be dismissed. See, *e.g.*, *Baldwin v. Rica Foods*, Case No. 02-20070-CIV-HUCK/TURNOFF, Slip. Op. at 12 (Oct. 29, 2002) (dismissing complaint for failure to allege loss causation) (Jt. App. Ex. F).

IV. PLAINTIFFS' CLAIMS AGAINST E&Y ARE BARRED BY THE STATUTE OF LIMITATIONS

Plaintiffs were required to bring their Section 10(b) claim "within one year after the discovery of the facts constituting the violation and within three years after such violation." *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991). They were required to bring their claim under Section 11 "within one year after the discovery of the untrue statement or

[8] On the date this lawsuit was commenced, the price of Triton stock was 60 cents a share – 16 cents *higher* than its price before the corrective disclosure. See Ex. D.

[9] Even if plaintiffs were now to suggest that the November 2000 announcement regarding ART was also a "corrective disclosure" (notwithstanding their previous allegation that this announcement was false and misleading (Am. Cplt. ¶ 152)), the following drop in stock price would not establish loss causation *as to E&Y*. As described above, E&Y made no representation regarding ART's ability to pay for merchandise purchased from Triton; thus, even if the November 2000 announcement corrected a prior misstatement by some other actor, it did not correct a prior misstatement by E&Y.

the omission . . . ." 15 U.S.C. § 77m.[10] Plaintiffs first filed suit on June 11, 2002, more than a year after they received notice of their possible claims. The Amended Complaint therefore should be dismissed. See, *e.g.*, *Theoharous v. Fong*, 256 F.3d 1219 (11th Cir. 2001) (affirming dismissal of complaint for failure to comply with statute of limitations).[11]

"Discovery" of the facts constituting a violation "'occurs when a potential plaintiff has inquiry or actual notice of a violation.'" *Id*. at 1228 (quoting *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 670 (7th Cir. 1998)). "Inquiry notice is the term used for knowledge of facts that would lead a reasonable person to begin investigating the possibility that his legal rights had been infringed." *Theoharous*, 256 F.3d at 1228 (internal citation omitted). Thus, a plaintiff's claim will be barred if publicly-available information or documents "sufficiently alert[] the plaintiffs to the possibility of the fraud." *Franze v. Equitable Assurance*, 296 F.3d 1250, 1255 (11th Cir. 2002) (concluding that named plaintiffs had not filed complaints within time required by statute of limitations).

Plaintiffs were on inquiry notice of one of the cornerstones of Triton's alleged fraud – its supposed misrepresentations about ART's ability to honor its commitments – more than a year before the first complaint was filed in this case. In November 2000, Triton announced that ART was requesting a delay of deliveries in order to "conserve cash" until it "obtained additional

[10] Although the Sarbanes-Oxley Act of 2002, Pub. L. No 107-204, 116 Stat. 745 (July 30, 2002), extended the statute of limitations for securities claims to two years after discovery of the violation and five years after the violation (see Sarbanes-Oxley Act § 804(a)), the new and longer statute of limitations applies only to "proceedings. . . that are *commenced* on or after the date of enactment of th[e] Act." *Id*. § 804(b) (emphasis added). The instant action was filed before July 30, 2002, the date on which the Sarbanes-Oxley Act was signed into law.

[11] The statute of limitations, like any affirmative defense, may be resolved on a motion to dismiss where "the complaint affirmatively and clearly shows the conclusive applicability of the defense to bar the action." *Reisman v. General Motors Corp.*, 845 F.2d 289, 291 (11th Cir. 1988) (internal quotation omitted).

financing." Am. Cplt. ¶¶ 71, 150. Such a clear statement that ART was experiencing cash flow deficiencies was "sufficient to put [the plaintiff] on inquiry notice of the possibility" that Triton had made a misstatement "with its prior assurances of [ART's] financial health." *Theoharous*, 256 F.3d at 1228. Particularly when coupled with ART's bankruptcy filing, which was announced by Triton in March 2001, these disclosures imposed a duty on plaintiffs to inquire into the accuracy of Triton's statements regarding its financial condition.

Nor can plaintiffs rescue parts of the Amended Complaint simply by arguing that they had inquiry notice of only one, but not all, elements of the putative fraud. "Once on inquiry notice, plaintiffs . . . are held to have constructive notice of *all* facts that could have been learned through diligent investigation during the limitations period." *In re NAHC, Inc. Sec. Litig.*, 306 F.3d 1314, 1326 (3d Cir. 2002) (internal quotation omitted) (emphasis added). And in this case, there is not a single aspect of the alleged fraud that plaintiffs could not have discovered had they conducted a "diligent investigation during the limitations period." Indeed, for nearly every other piece of the fraud that plaintiffs now allege, they quote at least one former Triton employee who had left the company prior to or during the limitations period. See, *e.g.* Am. Cplt. ¶¶ 50 (defective product), 64 (recognition of revenues); 104 (related parties); 188 (bill and hold). There is no reason why plaintiffs could not have interviewed these former employees at the time they were put on inquiry notice. "'Inquiry notice is triggered by the possibility of fraud, *not by full exposition of the scam itself*.'" *Franze*, 296 F.3d at 1254 (quoting *Theoharous*, 256 F.3d at 1228) (emphasis added). Accordingly, plaintiffs' claims should be dismissed.

CONCLUSION

For the foregoing reasons, all claims against E&Y in the Amended Complaint should be dismissed with prejudice.

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