UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

Bhushan Athale, Individually and on Behalf of All Others Similarly Situated, Plaintiff, –v– SinoTech Energy Limited, et al., Defendants.	11-cv-5831 (AJN) MEMORANDUM & ORDER

ALISON J. NATHAN, District Judge:

This is a securities action brought on behalf of a putative class of SinoTech Energy Limited ("SinoTech" or "Company") shareholders against Defendant Ernst & Young Hua Ming ("EYHM"), which issued an allegedly fraudulent Audit Opinion that was included in SinoTech's March 31, 2011, Form 20-F. Before the Court is EYHM's motion to dismiss the Third Amended Complaint. For the reasons below, the motion is granted and the Clerk of Court is ordered to terminate the case.

I. Background

The following facts are taken from the Third Consolidated Amended Complaint ("TAC"). *See* Dkt. No. 134. In addition, the Court considers the March 31, 2011, Form 20-F filed by SinoTech and the Alfred Little Report, which are incorporated into or attached to the complaint and are therefore "deemed part of the pleading," *Roth v. Jennings*, 489 F.3d 499, 509 (2d Cir. 2007). The facts asserted in these documents are assumed to be true for purposes of deciding this motion. The Court, furthermore, takes judicial notice of certain documents outside

the complaint for the limited purpose of "determin[ing] *what* the documents state[]," but not to "prove the truth of their contents." *Roth*, 489 F.3d at 509 (emphasis in original).

The Court assumes familiarity with the facts of this case, which are set forth in brief in the order granting EYHM's previous motion to dismiss. *See* Dkt. No. 123. SinoTech purported to be "a fast-growing and profitable provider of enhanced oil recovery ("EOR") services in the People's Republic of China." TAC ¶ 2. On November 3, 2010, SinoTech conducted an initial public offering, raising approximately $120.7 million in net proceeds. *Id.* ¶ 21. A few months thereafter, on March 31, 2011, SinoTech filed an Annual Report on Form 20-F with the SEC. *Id.* ¶ 22. The Annual Report contained Defendant EYHM's Audit Opinion, which stated that the financial statements contained in the Form 20-F "present[ed] fairly, in all material respects, the consolidated financial position of [SinoTech] as of September 30, 2010, and the consolidated results of its operations and its cash flows for the year ended September 30, 2010, in accordance with U.S. generally accepted accounting principles." *Id.* ¶¶ 22, 32.

On August 16, 2011, the short seller analysts known as Alfred Little issued a report ("Report") entitled, "SinoTech Energy: Enhanced Oil Recovery of Capital Extraction?" *Id.* ¶ 23. Significantly, the Report asserted that: (1) Dongying Luda Petrochemical Equipment Co. ("Dongying Luda"), to whom SinoTech had reportedly paid approximately $65 million for the import of lateral hydraulic drilling ("LHD") equipment, was a shell company with no operations; (2) SinoTech's chemical supplier Tianjin Shanchuan Petroleum Chemicals Co. ("Tianjin Shanchuan"), was a shell company with little to no revenue; and (3) two of the SinoTech's subcontracting customers, Hebei Daofu and Panjin Hanyu—who were reported to account for nearly half of SinoTech's revenues during the year ended September 30, 2010—were likewise shell companies with "minimal revenues and unverifiable operations." *Id.* ¶ 24; *see also* TAC

Ex. A (Report), at 13-19. According to the Report, this network of shell companies had been used to inflate SinoTech's assets and revenues. In response to the report, NASDAQ immediately halted trading in SinoTech. *Id.* ¶ 24. On September 23, 2011, SinoTech filed a Form 6-K with the SEC, which included a September 23, 2011 press release disclosing that EYHM had withdrawn its Audit Opinion and resigned as SinoTech's independent auditor. *Id.* ¶ 25.

On April 24, 2014, Plaintiff filed the Third Amended Complaint, alleging that EYHM violated § 10(b) and Rule 10b-5 of the Exchange Act. *See* Dkt. No. 134. Shortly thereafter, Defendant EYHM moved to dismiss for failure to state a claim, arguing that the TAC does not adequately plead that EYHM issued its Audit Opinion with the requisite scienter. *See* Dkt. No. 137.

II. Discussion

In order "[t]o state a claim under § 10(b) and Rule 10b-5, a plaintiff must plead that: (1) the defendant made a false statement or material omission; (2) the defendant did so with scienter . . . ; [and] (3) the plaintiff relied on the statement or omission, which in turn caused the plaintiff injury." *Iowa Pub. Employees Ret. Sys. v. Deloitte & Touche LLP*, 919 F. Supp. 2d 321, 330 (S.D.N.Y. 2013) (citing *Kalnit v. Eichler*, 264 F.3d 131, 138 (2d Cir. 2001)). In its motion to dismiss, EYHM only challenges the adequacy of Plaintiff's pleadings with respect to the second prong, regarding whether EYHM issued the Audit Opinion with sufficient scienter. For the reasons that follow, the Court finds that the pleadings as to scienter are inadequate and grants the motion to dismiss.

A. Pleading Auditor Scienter

In the ordinary case, all that is necessary for a complaint to survive a motion to dismiss under Rule 12(b)(6) is for the "plaintiff [to] provide the grounds upon which his claim rests

through factual allegations sufficient 'to raise a right to relief above the speculative level." *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir. 2007) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555 (2007)). In determining whether this standard has been met, the Court must "accept[] all factual allegations in the complaint and draw[] all reasonable inferences in the plaintiff's favor." *Id.* However, securities fraud actions are additionally subject to the heightened pleading standards set forth in Federal Rule of Civil Procedure 9(b) and the PSLRA. *See ATSI*, 493 F.3d at 99 (citing 15 U.S.C. § 78u–4(b)(3)(A)); *Kalnit v. Eichler*, 264 F.3d 131, 138-39 (2d Cir. 2001). Under Rule 9(b), a party "alleging fraud or mistake . . . must state with particularity the circumstances constituting fraud or mistake." Fed. R. Civ. P. 9. Under the PSLRA, a plaintiff bringing a claim under Section 10(b) and Rule 10b-5 must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *Iowa Pub. Employees Ret. Sys.*, 919 F. Supp. 2d at 330-31; *accord Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 319 (2007).

To meet this "strong inference" standard, the inference regarding the defendant's state of mind "need not be irrefutable. . . or even the most plausible of competing inferences" generated by the allegations in the complaint, but it must nevertheless be "cogent and compelling, thus strong in light of other explanations." *Tellabs*, 551 U.S. at 324. That is, the inference of scienter must be "at least as compelling as any opposing inference one could draw from the facts alleged." *Id.* This inquiry is "inherently comparative" and accordingly requires consideration of "plausible, nonculpable explanations for the defendants conduct, as well as inferences favoring the plaintiff." *Id.* at 323-24. To meet this standard, it must be the case that "a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Id.* at 324.

Demonstrating scienter "requires a showing of intent to deceive, manipulate, or defraud, or reckless conduct." *ATSI*, 493 F.3d at 99 n.3 (internal citation and quotation marks omitted).[1] In this context, conduct is reckless if it is "highly unreasonable" and "represents an extreme departure from ordinary care to the extent that *the danger was either known to the defendant or so obvious that the defendant must have been aware of it.*" *S. Cherry Street, LLC v. Hennessee Grp. LLC*, 573 F.3d 98, 109 (2d Cir. 2009) (emphasis in original). Moreover, as the Second Circuit has repeatedly emphasized, "there are limits to the scope of liability for failure adequately to monitor the allegedly fraudulent behavior of others," *id.* (quoting *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000)), including, crucially, the prohibition on proceeding via "allegations of 'fraud by hindsight,'" *Novak*, 216 F.3d at 309. Thus, "[f]or recklessness on the part of a non-fiduciary accountant [to] satisfy . . . the requirement of scienter, it must approximate an actual intent to aid in the fraud being perpetrated by the audited company." *Id.* (internal citations and quotation marks omitted). This state of mind may be pleaded through allegations that "show[] that the defendants had both motive and opportunity to commit the fraud," or that otherwise "constitut[e] strong circumstantial evidence of conscious misbehavior or recklessness." *Fezzani v. Bear, Stearns & Co. Inc.*, 716 F.3d 18, 22 (2d Cir. 2013). If plaintiffs proceed without a theory of motive, but rather on the basis of circumstantial evidence alone, "the strength of the circumstantial allegations must be correspondingly greater." *Kalnit*, 264 F.3d at 142.

In this case, Plaintiff argues that the TAC pleads facts constituting strong circumstantial evidence of recklessness. *See* Pl. Opp. 8-9; TAC ¶¶ 96-104. In particular, Plaintiff points to the

[1] While the Supreme Court has "reserved the question whether reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5," "[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly," *Tellabs*, 551 U.S. at 319 n.3, including the Second Circuit. *See In re Carter-Wallace, Inc., Sec. Litig.*, 220 F.3d 36, 39 (2000).

following pieces of circumstantial evidence, as alleged in the TAC: (1) the material weaknesses in SinoTech's internal controls; (2) the increase in production equipment; (3) the fact that SinoTech's import agent, chemical supplier, and two of its subcontractors were shell companies; and (4) "the scale of the fraud." *See* Pl. Opp. 9-23. These arguments and their cumulative impact are addressed below. *See Tellabs*, 551 U.S. at 322-23 ("The inquiry . . . is whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.").

B. Disclosed Weaknesses in Internal Controls

Plaintiff first argues that something "unusual about SinoTech . . . required [EYHM] to expand the scope and nature of its auditing procedures in connection with SinoTech's audit" to include procedures to verify the existence and condition of SinoTech's LHD units, confirm the accounts receivable from Hebei Daofu and Panjnin Hanyu, and "obtain a legitimate understanding of" SinoTech's arrangements with Dongying Luda and Tianjin Shanchuan. Pl. Opp. 11; TAC ¶ 100. In particular, Plaintiff argues that such an expanded audit was necessitated by the following disclosure regarding "material weaknesses" in SinoTech's internal controls contained in SinoTech's Form 20-F:

> In connection with the audit of our consolidated and other financial statements included in this annual report, we and our independent registered public accounting firm identified the following control deficiencies, which amounted to "material weaknesses" as defined under the standards established by the Public Accounting Oversight Board: (i) insufficient U.S. GAAP qualified accounting and finance personnel and (ii) ineffective process for documenting and applying accounting policies and procedures.

TAC ¶ 64. Given these known deficiencies, Plaintiff argues that EYHM's failure to engage in an expanded audit rendered its audit so deficient that it "amounted to no audit at all." Pl. Opp. 9. For the reasons that follow, the Court rejects this argument.

At base, Plaintiff's argument is that EYHM's failure to "expand the 'nature and scope' of the auditing procedures" in light of the disclosed deficiencies in internal control violated general accepted accounting standards, specifically GAAS Standard of Field Work No. 2. TAC ¶ 65. But it is well established that mere "[a]llegations of GAAS violations without corresponding fraudulent intent are insufficient to state a securities fraud claim against an independent accountant." *Meridian Horizon Fund, LP v. Tremont Grp. Holdings, Inc.*, 747 F. Supp. 2d 406, 412 (S.D.N.Y. 2010) (citing *Rothman v. Gregor*, 220 F.3d 81, 98 (2d Cir. 2000); *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 270 (2d Cir. 1996)). Rather, such violations "establish[], at most, negligence." *In re Longtop Fin. Techs. Ltd. Sec. Litig.*, 939 F. Supp. 2d 360, 390 (S.D.N.Y. 2013) ("*Longtop II*"). Thus, the mere allegation that EYHM violated GAAS by failing to expand its audit in light of the disclosed material weaknesses is insufficient to meet the standard of recklessness in the private securities fraud context, which requires instead "a state of mind *approximating actual intent*, and *not merely a heightened form of negligence*." *S. Cherry*, 573 F.3d at 109 (emphasis in original).

The Court further notes that, rather than allege that EYHM essentially failed to conduct any audit at all, Plaintiff alleges that EYHM recklessly failed to undertake an *expanded* audit encompassing *additional* procedures beyond the ordinary scope of an audit, such as physically inspecting production equipment. *See* TAC ¶¶ 65, 74-75. In other words, Plaintiff's own allegations make clear that EYHM *did* conduct an audit, notwithstanding its conclusory assertion that "EYHM's audit amounted to no audit at all." Pl. Opp. 9. The Court is unpersuaded that EYHM's alleged failure to *expand* the audit to address the recommended additional procedures rendered the audit so shoddy as to constitute "no audit at all," which is what is required in order

to demonstrate a reckless mindset. *Stephenson v. PricewaterhouseCoopers, LLP*, 482 F. App'x 618, 623 (2d Cir. 2012).

Moreover, the "material weaknesses" disclosed in the Form 20-F, which relate specifically to SinoTech's having an insufficient number of "U.S. GAAP qualified accounting and finance personnel" and "ineffective process for documenting and applying accounting policies and procedures," TAC ¶ 64, bear no relationship with the underlying fraud, which involved the intentional overstatement of SinoTech assets and revenues through the use of shell companies. *See Id.* ¶ 23. Nor do Plaintiff's allegations otherwise support an inference that there was such a link. *Cf. Varghese v. China Shenghuo Pharmaceutical Holdings, Inc.*, 672 F. Supp. 2d 596, 610 (S.D.N.Y. 2009) (finding known problems with internal controls highly probative of auditor's state of mind regarding audited company's inaccurate financial reporting). On the contrary, Plaintiff's allegations suggest that SinoTech *had* taken affirmative steps to redress the disclosed weaknesses, such as by "identifying and hiring additional personnel with U.S. GAAP and SEC reporting experience" and "providing training to [its] finance personnel to improve their knowledge of U.S. GAAP and SEC reporting requirements and deadlines." TAC ¶ 64. Under these circumstances, the Court finds that the allegations do not support the inference that it was "highly unreasonable" for EYHM to fail to expand the scope of its audit to include, for example, inspection of physical assets, when confronted with SinoTech's failure to hire sufficient U.S. GAAP qualified accounting personnel. *S. Cherry*, 573 F.3d at 109; *see also In re IMAX Sec. Litig.*, 587 F. Supp. 2d 471, 483 (S.D.N.Y. 2008) ("[A] plaintiff must allege . . . that the accounting judgments which were made were such that no reasonable accountant would have made the same decision if confronted with the same facts."). Accordingly, the Court does not

find that EYHM's apparent failure to expand the scope of its audit was reckless in light of the disclosed material weaknesses in SinoTech's internal controls.

C. Material Increase in Production Equipment

Plaintiff similarly argues that "the material increase of SinoTech's production equipment during the year ended September 30, 2010," in combination with the disclosed weaknesses in their internal controls, required EYHM "to expand the nature and scope of the auditing procedures it applied in auditing SinoTech's production equipment assets." TAC ¶ 68. Specifically, Plaintiff alleges that, "[d]uring the year ended September 30, 2010, SinoTech's reported assets increased by $70 million, from $95.2 million on September 30, 2009 to $165.2 million on September 30, 2010," and that in light of this growth EYHM should have "obtain[ed] audit evidence to verify SinoTech's valuation and ownership" of $52.2 million in newly acquired LHD units, which comprised 75% of the reported increase in assets. *Id.* ¶¶ 67, 73-74, 100. According to Plaintiff, EYHM's apparent failure to do so renders its audit reckless. Again, the Court disagrees that the facts alleged state a claim under the applicable standard.

Similar to Plaintiff's previous argument, this one boils down to an allegation that EYHM's failure to expand its audit procedures violated GAAS. In particular, Plaintiff alleges that EYHM violated: (1) AU § 312, which directs auditors to "consider audit risk and materiality" when designing audit procedures and "obtain sufficient competent evidential matter" when "evaluating whether the financial statements taken as a whole are presented fairly"; (2) AU § 326, which, among other things, requires auditors to "obtain sufficient competent evidential matter . . . to afford a reasonable basis for an opinion regarding the financial statements under audit"; and (3) AU § 330, which governs the "confirmation process." However, as previously discussed, mere "[a]llegations of GAAS violations without corresponding fraudulent intent are

insufficient to state a securities fraud claim against an independent accountant." *Meridian Horizon Fund*, 747 F. Supp. 2d at 412 (citing *Rothman*, 220 F.3d at 98; *Chill*, 101 F.3d at 270). Rather, such allegations "establish[], at most, negligence." *Longtop II*, 939 F. Supp. 2d at 390.

The Court is, furthermore, unpersuaded that the increased acquisition of production equipment—particularly the $52.2 million in LHD units—was so suspicious as to make EYHM's alleged failure to expand its audit procedures "highly unreasonable" enough so as to constitute recklessness. *S. Cherry Street*, 573 F.3d at 109. Prior to the filing of the Form 20-F in question, at the time of its IPO, SinoTech filed a Form F-1 disclosing that it intended to use approximately $51 million of "the net proceeds [it] receive[d] from [the] offering" to repay a loan that was "used to finance [its] purchase of six LHD units and further purchase . . . two additional LHD units." *See* Martin Decl. Ex. 2, at 44. SinoTech further disclosed that it anticipated using an additional $69.7 million of the IPO proceeds to "[m]ake LHD equipment-related capital expenditures." *Id.* Under these circumstances, SinoTech's reported acquisition of $52.2 million in equipment was not so indicative of fraud as to necessitate EYHM's suspicion. Indeed, it would have been more suspicious had SinoTech *failed* to report such a notable increase in the value of its LHD Units.

Nor is the Court persuaded that *no reasonable auditor* would have failed to undertake the expanded procedures identified by Plaintiff—which include, among other things, "physical inspect[ion] or observ[ation] of the LHD units" and "examin[ation] [of] purchase agreements and/or contracts between SinoTech and Jet Drill," the putative supplier. TAC ¶ 74. Significantly, these procedures do not appear to be mandated by the GAAS provisions relied upon by Plaintiff. For example, GAAS, AU § 312, does not directly call for these sorts of procedures, but more generally direct auditors to "consider audit risk and materiality" in

planning the audit and in determining "whether the financial statements taken as a whole are presented fairly," which further requires the auditor "to obtain sufficient competent evidential matter on which to properly evaluate the financial statements." *Id.* ¶ 66. Likewise, GAAS, AU § 326 contains no express directive for auditors to physically inspect the production equipment of their clients, but rather advises auditors to "obtain sufficient competent evidential matter through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit." *Id.* ¶ 70 (citing GAAS, AU §312).

In an attempt to demonstrate that these GAAS provisions require the type of audit procedures identified, Plaintiff relies upon the appendix to AU § 326, which contains illustrative examples of its applications. *See Id.* ¶ 71. However, as EYHM points out, the illustrative examples relied upon by Plaintiff specifically concern the audited entity's *inventories*, and *not* production equipment such as the LHD units at issue here. *See Id.* ¶ 71 (suggesting that auditors "[o]bserve physical inventory counts" in order to achieve the "Illustrative Audit Objective[]" of determining whether "[i]nventories included in the balance sheet physically exist"). Plaintiff does not otherwise allege that any reasonable accountant would have decided to engage in the expanded procedures under the circumstances presented. This failure to allege facts demonstrating that no reasonable auditor would have done as EYHM did—that is, would have failed to conduct an *expanded* audit including, e.g., physical inspection of the LHD units—further weighs against a finding that Plaintiff has adequately pleaded scienter on this basis. *See Iowa Pub. Emp's*, 919 F. Supp. 2d at 333.

D. Third-Party Confirmations

Plaintiff further argues that Defendant recklessly failed to confirm SinoTech's arrangements with subcontractors Hebei Daofu and Panjin Hanyu, import agent Dongying Luda,

and chemical supplier Tianjin Shanchuan. *See* TAC ¶¶ 80-90. Again, Plaintiff's argument is rejected.

With respect to subcontractors Hebei Daofu and Panjin Hanyu, Plaintiff's allegations are undergirded by another provision of GAAS. In particular, Plaintiff argues that, pursuant to AU § 330, EYHM was obligated to confirm accounts receivable with Hebei Daofu and Panjin Hanyu. *See* TAC ¶¶ 80-84. Had EYHM done so, Plaintiff argues, "it would have learned, if it did not already know, that more than one third of SinoTech's accounts receivable . . . could not be confirmed by Hebei Daofu and Panjin Hanyu" because they were shell companies. TAC ¶ 84.

Significantly, however, Plaintiff does not allege facts indicating that EYHM violated AU § 330 by failing to confirm the accounts receivable with Hebei Daofu and Panjin Hanyu. Rather, Plaintiff asks that the Court *infer* that no such confirmations took place on the basis of EYHM's failure to discover the fraud. *See* Pl. Opp. 17-18. In making this argument, Plaintiff emphasizes that Hebei Daofu and Panjin Hanyu were "shell companies with no operations at any physical address or phone numbers." Pl. Opp. 17. But there is no requirement that an auditor confirm accounts receivable by visiting a third-party's physical address or through placing a telephone call. Use of the mail is a common and accepted medium for reaching these parties. *See* AU § 330.28. As the Report indicates, the shell companies had mailing addresses, even if no business was actually conducted at those addresses. *See* TAC Ex A, at 14; *see also* TAC Ex. A, at 30 ("[T]he auditor, unlike our ground investigators, does not have the mandate or ability to scrutinize the operations of [SinoTech's] purported customers, suppliers or import agent"). Indeed, as the Report recognizes, the very *purpose* of the shell companies was to "generate mountains of paper based documents to help [SinoTech] pass an audit." *Id.* Under these

circumstances, the Court finds that Plaintiff's allegations do not support the inference that EYHM failed to confirm accounts receivable in violation of GAAS.

Even if EYHM *had* failed to confirm accounts receivable in violation of GAAS, such violations would not, on their own, be sufficient to establish recklessness. *See Meridian Horizon Fund*, 747 F. Supp. 2d at 412 ("Allegations of GAAS violations without corresponding fraudulent intent are insufficient to state a securities fraud claim against an independent accountant."). After all, the relevant question is not whether EYHM "*should have* probed more forcefully into the relationship between" SinoTech and the shell companies, but whether "*no reasonable auditor* . . . would have made the decision to issue a clean audit report." *Iowa Pub. Emp.'s*, 919 F. Supp. 2d at 336. Plaintiff's allegations—which again, are based solely on EYHM's apparent failure to discover the underlying fraud—do not meet this standard.

With respect to import agent Dongying Luda and chemical supplier Tianjin Shanchuan, Plaintiff's allegations are even weaker. Plaintiff merely asserts that EYHM's apparent failure to confirm SinoTech's arrangements with these companies indicated a "lack of care." TAC ¶¶ 88, 90. These allegations, even if true, are insufficient to establish scienter, because proving that EYHM acted with a "lack of due care" would establish, at most, only negligence. *See Berwind-White Coal-Mining Co. v. Bush Terminal Co.*, 296 F. 475, 477 (2d Cir. 1924) (defining negligence as "lack of care under the circumstances). Scienter, however, requires "a state of mind approximating actual intent, and *not merely a heightened form of negligence*." *S. Cherry*, 573 F.3d at 109.

Furthermore, "[t]he notion that a firm hired to audit the financial statements of one client . . . must conduct audit procedures on a third party that is not an audit client . . . on whose financial statements the audit firm expresses no opinion *has no basis*." *In re Tremont Sec. Law*,

703 F. Supp. 2d 362, 371 (S.D.N.Y. 2010) (emphasis added); *see also Iowa Pub. Emp. 's*, 919 F. Supp. 2d at 337-39 (finding that auditor, "as a matter of law, [could not] be held accountable for red flags or representations in statements of unaudited, non-client entities."). Or, as the Report disclosing the underlying fraud puts it, "the auditor . . . does not have the mandate or ability to scrutinize the operations of [SinoTech's] purported customers, suppliers, or import agent." TAC Ex. A, at 30. Accordingly, the Court finds that allegations regarding EYHM's failure to confirm SinoTech's arrangements with its subcontractors, import agent, and chemical supplier do not give rise to an inference of scienter.

E. Remaining GAAS and GAAP Violations

In addition, Plaintiff asserts that EYHM violated a laundry list of other GAAS provisions in the course of its audit. *See* TAC ¶¶ 91(a)-(f), 92. For example, Plaintiff asserts that "[EYHM] violated auditing standard AU § 316, which requires auditors to plan and perform an audit to obtain reasonable assurance about whether financial statements are free from misstatements caused by error or fraud," *id.* ¶ 91(a), and that "[EYHM] violated AU § 317, which prescribes the nature and extent of the consideration an independent auditor should give to the possibility of illegal acts by a client in an audit of financial statements," *id.* ¶ 91(b). Plaintiff further alleges that each of these "auditing standards [was] violated because [EYHM] failed to obtain a modicum of audit evidence to justify its opinion" and its audit was therefore "tantamount to no audit at all." *Id.* ¶ 93. As these excerpts from the pleadings demonstrate, Plaintiff's allegations consist of threadbare assertions that particular provisions of GAAS were violated, without any "evidence of corresponding fraudulent intent," and they are therefore insufficient to establish scienter for purposes of stating a securities fraud claim. *Novak*, 216 F.3d at 309.

F. Magnitude of Fraud

Finally, Plaintiff alleges that the magnitude of the fraud provides circumstantial evidence of scienter. As set forth in the Third Amended Complaint, SinoTech's assets were overstated by approximately $51 million or 45%, SinoTech's production equipment had been overstated by approximately 407%, and SinoTech's revenue had been overstated by approximately 75%. *See* Pl. Opp. 21. "Given the size of the fraud," Plaintiff alleges, "EYHM simply could not have missed it." *Id.* 22. However, "a fraud's large size, standing alone, is insufficient to show recklessness." *In re Longtop Fin. Techs. Ltd. Sec. Litig.*, 910 F. Supp. 2d 561, 578 (S.D.N.Y. 2012) ("*Longtop I*") (citing *Pennsylvania Pub. Sch. Employees' Ret. Sys. v. Bank of America Corp.*, 874 F.Supp.2d 341, 362–63 (S.D.N.Y. 2012)). The Court accordingly declines to find that scienter is established by the size of the fraud.

G. Cumulative Allegations

Under *Tellabs*, the inquiry is "whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." 551 U.S. at 322-323. Accordingly, the Court now turns to consider the cumulative impact of Plaintiff's allegations and whether they are sufficient to establish a strong inference of scienter. The Court finds that they are not.

Examination of the TAC as a whole makes clear that Plaintiff's theory, in essence, is that if EYHM had performed certain additional audit procedures, it would have discovered the fraud sooner. *See, e.g.*, TAC ¶ 79 ("Had [EYHM] confirmed the terms of the Company's purported purchases . . . it would have discovered that the 2010 Financial Statements overstated SinoTech's assets at September 30, 2010 by $51 million"); *see also id.* ¶¶ 84, 87, 88, 90, 91, 94. EYHM's apparent failure to conduct these procedures, Plaintiff contends, was sufficiently reckless to demonstrate scienter. *See id.* From Plaintiff's current vantage point, it is easy enough to identify

steps that EYHM could have taken to discover the fraud more quickly than it did. But "[f]raud is always obvious in retrospect, [and] it is not reckless to lack clairvoyance." *Longtop I*, 910 F. Supp. 2d at 579. For this reason, the Second Circuit has long "refused to allow plaintiffs to proceed with allegations of fraud by hindsight." *Novak*, 216 F.3d at 309 (citing *Stevelman v. Alias Research*, 174 F.3d 79, 85 (2d Cir. 1999)). Accordingly, the Court finds that Plaintiff has not plead facts giving rise a strong inference of scienter, and therefore has failed to state a claim for securities fraud under § 10(b) or Rule 10b-5. *See Tellabs*, 551 U.S. at 324.

Furthermore, consideration of "plausible, nonculpable explanations for the defendants conduct, as well as inferences favoring the plaintiff," *id.* at 323-24, reinforces the Court's conclusion. The more compelling inference generated by the pleadings is that EYHM failed to discover or disclose the fraud not because of its own recklessness, but because great lengths were taken to conceal the fraud from prying eyes. *Cf. Meridian Horizon Fund, LP v. KPMG (Cayman)*, 487 Fed. App'x 636, 641 (2d Cir. 2012) (finding that "the more compelling inference as to why Madoff's fraud went undetected for two decades was his proficiency in covering up his scheme and deceiving the SEC and other financial professionals"). Indeed, the pleadings generate the compelling inference that EYHM was one of the principal *targets* of the fraud, rather than its perpetrator. Significantly, Alfred Little discovered the fraud by engaging in the kind of detective work—involving "on the ground investigators" who telephoned, visited, and photographed the reported worksites of various third-party entities—that auditors typically have neither "the mandate or ability" to undertake. TAC Ex. A, at 30. As the Report emphasizes, "[t]he only thing such shell companies are good for producing is mountains of paper based documents to help [SinoTech] pass an audit." *Id.* Under these circumstances, the mere fact that

SinoTech passed its audit does not demonstrate that EYHM acted with a state of mind "approximating actual intent" to aid in the fraud being perpetrated. *Novak*, 216 F.3d at 313.

III. Conclusion

For the foregoing reasons, Defendant's motion to dismiss is granted, and the Clerk of Court is requested to terminate the case. This resolves Dkt. No. 137.

SO ORDERED.

Dated: January 23, 2015
New York, New York

ALISON J. NATHAN
United States District Judge

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