No. 06-11368

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

DALE R. TEMPLIN, Individually and on Behalf of All Others Similarly Situated,
Plaintiff-Appellant,

v.

SOURCECORP INC.; ED H. BOWMAN, JR.; BARRY EDWARDS; IMAGE ENTRY INC.,
Defendants-Appellees.

****

DALE R. TEMPLIN,
Plaintiff-Appellant,

v.

SOURCECORP INC.; ED H. BOWMAN, JR.; BARRY L. EDWARDS,
Defendants-Appellees.

****

GEORGE REICHL, Individually and on Behalf of All Others Similarly Situated,
Plaintiff-Appellant,

DALE R. TEMPLIN,
Appellant,

v.

SOURCECORP INC.; ED H. BOWMAN, JR.; BARRY EDWARDS,
Defendants-Appellees.

****

DALE R. TEMPLIN,
Appellant,

v.

SOURCECORP INC.; ED H. BOWMAN, JR.; BARRY EDWARDS,
Defendants-Appellees.

Appeal from the United States District Court
For the Northern District of Texas, Dallas Division
Civil Action No. 3:04-CV-2351-N

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CERTIFICATE OF INTERESTED PERSONS

In accordance with Fed. R. App. P. 26.1 and Fifth Circuit Rule 28.2.1, the undersigned counsel of record certifies that the following listed persons and entities as described in the fourth sentence of Rule 28.2.1 have an interest in the outcome of this case. These representations are made in order that the Judges of this Court may evaluate possible disqualification or recusal.

Parties

Dale R. Templin	Plaintiff-Appellant
George Reichl	Plaintiff-Appellant
Putative Plaintiff Class	
SOURCECORP, Inc.	Defendant-Appellee
Image Entry, Inc.	Defendant-Appellee
Ed H. Bowman, Jr.	Defendant-Appellee
Barry L. Edwards	Defendant-Appellee
Bill Deaton	Defendant

Insurers

Fireman's Fund Insurance Company

XL Specialty Insurance Company

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Image Entry Acquisition Corp. is the parent corporation of Image Entry, Inc.; CorpSource Holdings, LLC is the parent of SOURCECORP, Inc. (which is the parent of Image Entry Acquisition Corp.). No publicly held company owns 10% or more of the stock of SOURCECORP, Inc. or Image Entry, Inc.

Michael L. Davitt
Attorney for Defendants-Appellees
SOURCECORP, Inc., Image Entry, Inc.,
Ed H. Bowman, Jr., and Barry L. Edwards

STATEMENT REGARDING ORAL ARGUMENT

Appellees respectfully request oral argument because this case raises important issues about the scope of the Securities Exchange Act of 1934 and the strong-inference standard of the Private Securities Litigation Reform Act.

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STATEMENT OF ISSUES

1. Whether Plaintiffs established the "strong inference" of fraudulent intent required by the Private Securities Litigation Reform Act in the absence of any particularized allegations identifying information in Defendants' possession that was contrary to their allegedly inaccurate public statements.

2. Whether a securities fraud complaint under Section 10(b) of the Securities Exchange Act of 1934 can state a claim against a corporate subsidiary that did not make any of the alleged misstatements upon which Plaintiffs supposedly relied.

3. Whether the scienter of a rogue corporate employee who was acting for his own benefit and seeking to defraud his employers is nonetheless imputed to the corporation that employs him.

STATEMENT OF THE CASE

This appeal arises from the District Court's final judgment dismissing Plaintiffs' claims against the appellees. Purchasers of SOURCECORP, Inc. securities filed a class-action lawsuit against SOURCECORP, its subsidiary, Image Entry, Inc. ("Image"), and officers of both companies, alleging securities fraud violations under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 ("the 1934 Act"). *See* 15 U.S.C. §§ 78j(b), 78t(a). The District Court ruled that the claims against SOURCECORP, SOURCECORP's officers, and Image did not sufficiently plead scienter, and dismissed the claims under Federal Rule of Civil Procedure 12(b)(6). *See*

In re SOURCECORP Sec. Litig., No. 3:04-CV-2351-N, Amended Order at 3-10 (Nov. 7, 2006), R1716-23.[1] Plaintiffs now challenge the dismissal of these claims.

STATEMENT OF FACTS

1. SOURCECORP

SOURCECORP provides business process outsourcing solutions to private industries and various government entities. *See* SOURCECORP Form 10-K for Fiscal Year 2003, App. A to Defendants' Motion to Dismiss at 4.[2] Since its initial public offering in 1996, a key part of SOURCECORP's business strategy has been to acquire companies that will improve the quality and breadth of its services. *Id.* at 5. From 1996 through 2003, SOURCECORP acquired 65 companies, and by year-end 2003 it operated approximately 98 facilities in 26 states, Washington, D.C., and Mexico, and employed approximately 6,800 people. *Id.* at 4.

One of the 65 companies SOURCECORP acquired was Image.[3] *See* SOURCECORP Form 8-K (filed Apr. 12, 2001), R808. On March 31, 2001, a wholly-owned subsidiary of SOURCECORP called Image Entry Acquisition Corp. purchased all outstanding shares of Image for $43.75 million in cash and SOURCECORP stock. *See id.*, R808-09, 817. Under the terms of the stock purchase

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[1] Citations to the Record on Appeal are in the form "R__."

[2] On a motion to dismiss, courts may consider "public disclosure documents required by law to be, and that have been, filed with the SEC, and documents that the plaintiffs either possessed or knew about and upon which they relied in bringing the suit." *Fin. Acquisition Partners LP v. Blackwell*, 440 F.3d 278, 286 (5th Cir. 2006) (internal quotation marks omitted).

[3] At that time, SOURCECORP's name was "F.Y.I. Incorporated," but for the sake of consistency this brief will refer to the corporation as SOURCECORP throughout.

agreement, Image's CEO Bill Deaton and other former Image shareholders were eligible to receive from SOURCECORP up to an additional $25 million based on Image's financial performance during a three-year "earn-out" period. *See id.*, R817-18; Second Amended Consolidated Complaint ("Complaint") ¶ 15(c), R711.

2. Deaton's Scheme to Defraud SOURCECORP

According to the allegations of the Complaint, in an effort to obtain the earn-out bonus from SOURCECORP, Deaton falsified Image's revenue and expense figures over a three-and-a-half year period.[4] *See* Complaint ¶ 111, R740. This erroneous accounting was conducted "with one aim in mind: that Deaton would collect $25 million from SOURCECORP." *Id.* ¶ 6, R708. Deaton achieved this goal: SOURCECORP paid Deaton millions of dollars that he should not have received based on the inflated earnings figures that Deaton created for Image. *See id.* ¶ 119, R743.

Upon discovering a problem with the accounting at Image, SOURCECORP publicly announced that one of its subsidiaries had accounted improperly for revenue and that the public should no longer rely on previously issued financial statements. *See id.* ¶ 75, R730; *see* SOURCECORP Form 8-K (Oct. 27, 2004), R882. As SOURCECORP learned more through an investigation, it made further announcements regarding the nature and extent of the accounting errors at its

[4] As this appeal arises out of a motion to dismiss, this brief assumes the truth of the non-conclusory allegations of the Complaint.

subsidiary, *see* R895, 902, including that it determined the subsidiary had recognized revenue when one or more necessary conditions for revenue recognition had not been met.[5] *See* SOURCECORP Form 10-K for Fiscal Year 2004 at 24 (Mar. 31, 2005), R398. SOURCECORP also determined and disclosed that the subsidiary in certain instances recognized revenue for services not properly performed, and diverted expenses to corporations controlled by the subsidiary's management. *Id.* at 25, R399.

In a Form 8-K filed on March 23, 2005, SOURCECORP announced the restatement of its financial statements from 2001 through June 2004. *See* Complaint ¶ 118, R742. In total, over the three-and-a-half-year period, revenue decreased approximately 1% and expenses increased 0.4% due to the restatement. *Id.* ¶ 119, R743. This resulted in $33.9 million in downward adjustments to SOURCECORP's income from continuing operations before taxes. *Id.* Plaintiffs allege that, of that amount, $15.8 million (47%) represents earn-out overpayments that SOURCECORP made to Deaton and the other former Image shareholders. *Id.* The $33.9 million represented a 38.1% decrease from the bottom-line income previously reported for the relevant period. *Id.*

[5] SOURCECORP described the four necessary conditions as: "persuasive evidence of an arrangement exists, the price is fixed or determinable, delivery has occurred or services have been rendered and collection is reasonably assured." SOURCECORP Form 10-K for Fiscal Year 2004 at 24 (filed Mar. 31, 2005), R398.

3. Plaintiffs' Claims

Purchasers of SOURCECORP securities filed various securities-fraud actions, which were consolidated on March 25, 2005. R240-46. Plaintiffs filed a Second Amended Consolidated Complaint on October 28, 2005, alleging securities fraud violations based on the effect of the Image accounting inaccuracies on SOURCECORP's financial statements. *See* Complaint, R706-49. The Complaint alleges that "Deaton's and Image's passing inflated earnings numbers to parent SOURCECORP caused" SOURCECORP to overstate income in its financial reports, thereby inflating SOURCECORP's stock price, *id.* ¶¶ 115-16, R740, and ultimately harming shareholders when SOURCECORP restated its earnings and its stock price fell. *Id.* ¶ 132, R746.

According to Plaintiffs, SOURCECORP's financial statements were erroneous because Image improperly recorded revenue before delivering products to the customer, recorded revenue for excess product delivered, and shifted expenses to other entities. Complaint ¶ 110, R739-40. In addition, Plaintiffs allege that some subsidiaries did not have contracts to substantiate certain revenues, rendering false the SOURCECORP financial statements issued "from May 2001 through early 2003." *Id.* ¶ 4, R708. Plaintiffs also allege that the inflation of revenue and under-statement of expenses led SOURCECORP to make excessive "earn-out" payments to Deaton and other former Image shareholders. *Id.* ¶ 119, R743. Finally, Plaintiffs allege that SOURCECORP falsely certified that it had adequate internal controls, though

without identifying any specific internal control inadequacy other than the mere fact of reliance on Image's accounting and controls. *Id.* ¶ 22, R715.

The Complaint recognizes that the alleged misstatements resulted from Deaton's scheme to mislead SOURCECORP into believing the Image financial statements were accurate, and contains no allegations suggesting that SOURCECORP and its officers were not successfully misled. Nonetheless, the Complaint alleges that SOURCECORP and its officers acted with fraudulent intent in incorporating Image's results into SOURCECORP's financial statements. The Complaint likewise identifies no benefit to Image from Deaton's scheme, yet alleges fraudulent intent on the part of Image. Accordingly, Plaintiffs seek damages under Section 10(b) of the 1934 Act, and Rule 10b-5 promulgated thereunder, against SOURCECORP, Image, SOURCECORP CEO Ed Bowman, and SOURCECORP CFO Barry Edwards, along with former Image CEO Bill Deaton. *Id.* ¶ 126, R746. Plaintiffs also allege claims under Section 20(a) of the 1934 Act against SOURCECORP as a control person of Image, and against Bowman and Edwards as control persons of SOURCECORP and Image. *Id.* ¶¶ 134-36, R747-48.

4. The District Court Decision

On motions under Federal Rule of Civil Procedure 12(b)(6), the District Court on June 5, 2006, issued an order dismissing all of Plaintiffs' claims, except those against Deaton, for failure to state a claim. R1307-21. In an amended order issued November 7, 2006, the District Court restated its reasoning for dismissal, and entered

final judgment in favor of SOURCECORP, Bowman, Edwards, and Image, R1714-29, on the ground that, "the Complaint does not allege facts raising a strong inference of scienter," as required by the Private Securities Litigation Reform Act ("PSLRA"). Amended Order at 1, R1714.

In particular, the District Court explained, Bowman's and Edwards' knowledge of the alleged failures of internal controls or other facts could not simply be presumed based on their Sarbanes-Oxley certifications. Such certifications, by themselves, do not "show knowledge of falsity or recklessness," and "if otherwise the Court would be hard pressed to avoid finding scienter in any case that contained internal control allegations." *Id.* at 6, R1719. Furthermore, "the allegations that Edwards, as CFO, and Bowman as CEO should have known certain facts or had to be immersed in SOURCECORP's internal processes fail because '[a] pleading of scienter may not rest on the inference that defendants must have been aware of the misstatement based on their positions within the company.'" *Id.* (quoting *Abrams v. Baker Hughes Inc.*, 292 F.3d 424, 432 (5th Cir. 2002)). The District Court further noted that the only alleged factual basis for claims of scienter as to SOURCECORP's statements regarding revenue recognition was one conversation between Edwards and a confidential witness that might well have come after the purported misstatements, and, in any event, suggested SOURCECORP was working to correct any problems, not that it was knowingly ignoring them and lying about their existence. *Id.* at 7-8, R1720-21. Thus, taking Plaintiffs' allegations "collectively," the Complaint failed to allege facts

supporting a strong inference of scienter for Bowman and Edwards, and, consequently, for SOURCECORP. *Id.* at 8, R1721. Finally, because there was no predicate Section 10(b) violation, there was also no Section 20(a) violation. *Id.* at 9, R1722.

As for Image, the District Court held, the Complaint's attempt to impute Deaton's motive and knowledge to Image failed to establish the requisite "strong inference" of scienter because "'the knowledge and actions of employees acting adversely to the corporate employer cannot be imputed to the corporation.'" *Id.* at 9-10, R1722-23 (quoting *Kaplan v. Utilicorp United, Inc.*, 9 F.3d 405, 407 (5th Cir. 1993)). Here, the facts alleged in the Complaint showed Deaton was acting adversely to Image because "Image derived no benefit from Deaton's actions," and the Complaint provided no allegations to the contrary. *Id.* at 10, R1723.

Finally, the District Court denied Deaton's motion to dismiss, rejecting his argument that he could not be held liable because he did not "directly participate in SourceCorp's preparing communications with the public." *Id.* at 12, R1725. The District Court, without the benefit of this Court's recent opinion in *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, --- F.3d ---, 2007 WL 816518 (5th Cir. Mar. 19, 2007), held that it did not matter that Deaton did not actually make the misstatements that allegedly caused Plaintiffs' loss. Amended Order at 12-13, R1725-26. This Court denied Deaton's petition for permission to appeal on an interlocutory basis pursuant to 28 U.S.C. § 1292(b). *See Reichl v. Deaton*, No. 06-53 (Dec. 29, 2006).

SUMMARY OF ARGUMENT

Plaintiffs' effort to hold the victims of Bill Deaton's fraudulent activity liable for the consequences of Deaton's fraud cannot survive its own inherent illogic. As the Complaint itself alleges, Deaton intentionally misled SOURCECORP and its officers about Image's finances in a successful effort to defraud SOURCECORP of millions of dollars. Given this allegation that SOURCECORP officials were successfully misled about Image's finances, it is unsurprising that the Complaint can provide no particularized allegations supporting the claim that they acted with fraudulent intent in using those statements as part of SOURCECORP's financial results. This Court has repeatedly rejected such unsupported claims, including in cases with allegations almost identical to those made in this case.

In particular, Plaintiffs' claims against Bowman, Edwards, and SOURCECORP fail because the Complaint falls far short of alleging facts establishing the necessary strong inference that they acted with knowledge or severe recklessness that SOURCECORP's financial statements were false. Plaintiffs provide no specific allegations of any information available to Bowman or Edwards that would have revealed the truth about Image's accounting before SOURCECORP issued erroneous financial statements, relying instead on generalized allegations presuming knowledge of the falsity based on Bowman's and Edwards' positions in the company. This Court has repeatedly held such allegations inadequate for a strong inference of scienter, especially in accounting cases, and even more particularly in accounting cases

involving subsidiaries. In fact, the allegations here are essentially indistinguishable from those this Court found deficient in *Abrams*, 292 F.3d 424. Moreover, Plaintiffs allege no plausible motive for Bowman, Edwards, or SOURCECORP to have committed the fraud, and, indeed, the fraud actually harmed SOURCECORP, thereby making these defendants' alleged intent to commit the fraud totally nonsensical. In sum, Plaintiffs have not established any inference – let alone a strong inference – that SOURCECORP, Bowman, or Edwards had fraudulent intent.

Plaintiffs' claim against Image, SOURCECORP's subsidiary, fails for two independent reasons. First, Image did not make the alleged misstatements upon which Plaintiffs supposedly relied. As this Court held, Section 10(b) liability does not extend to those who merely participated in actions that enabled misstatements by others. *See Regents*, 2007 WL 816518. Accordingly, Image cannot be liable under Section 10(b) for SOURCECORP's erroneous financial statements.

Second, Plaintiffs fail to allege facts supporting a strong inference of scienter against Image because Deaton's knowledge – the sole basis on which Plaintiffs rely – cannot be imputed to Image. As this Court held in *Kaplan*, 9 F.3d 405, an officer's knowledge cannot be imputed to the company, for purposes of Section 10(b) liability, where the officer, as here, is acting adversely to the company. Because Deaton falsified Image's revenue and expenses solely to benefit himself, and was acting adversely to Image, his intent cannot be imputed to Image.

ARGUMENT

I. THE DISTRICT COURT CORRECTLY HELD THAT PLAINTIFFS FAILED TO ALLEGE PARTICULARIZED FACTS SUPPORTING A STRONG INFERENCE OF FRAUDULENT INTENT AS TO BOWMAN, EDWARDS, AND SOURCECORP.

Under the strict pleading standard of the PSLRA, a complaint alleging a Section 10(b) violation must, "with respect to each act or omission alleged to violate this chapter, state *with particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added). If a plaintiff fails to meet this requirement, the district court "shall," on defendant's motion, "dismiss the complaint." *Id.* § 78u-4(b)(3). Accordingly, "inferences of scienter do not survive if they are merely reasonable . . . . Rather, inferences of scienter survive a motion to dismiss only if they are both reasonable and 'strong' inferences." *R2 Invs. LDC v. Phillips*, 401 F.3d 638, 645 (5th Cir. 2005) (quoting *In re Navarre Sec. Litig.*, 299 F.3d 735, 741 (8th Cir. 2002)).

The relevant scienter for a Section 10(b) claim is "an intent to deceive, manipulate or defraud or equivalent severe recklessness." *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 367 (5th Cir. 2004); *see also Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (holding that a Section 10(b) claim requires "intent to deceive, manipulate, or defraud"). This requires "conscious behavior on the part of the defendant." *Lovelace v. Software Spectrum Inc.*, 78 F.3d 1015, 1019 (5th Cir. 1996). Moreover, the standard for "severe recklessness" is a stringent one, requiring

recklessness so severe as to "resemble[] a slightly lesser species of intentional misconduct." *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 408 (5th Cir. 2001).

As the District Court correctly held, Plaintiffs have failed to allege facts giving rise to a strong inference of fraudulent intent as to SOURCECORP, Bowman, or Edwards. Instead of identifying information available to Bowman or Edwards that conflicted with SOURCECORP's contemporaneous financial reports, the Complaint attempts to presume their knowledge of the fraud based on generalized and conclusory allegations of collective knowledge at SOURCECORP. This Court has consistently rejected such collective-knowledge allegations. Moreover, the idea that SOURCECORP, Bowman, and Edwards had the knowledge necessary for fraudulent intent is utterly implausible because, as the Complaint itself makes clear, the truth was actively and successfully hidden from them. Accordingly, the Complaint falls far short of satisfying the strong-inference requirement.

A. Plaintiffs Make Only Conclusory Allegations Of Collective Knowledge, Which This Court Has Repeatedly Held Do Not Satisfy The Strong-Inference Requirement.

Plaintiffs' conclusory allegations of collective knowledge in this case are precisely the sort of allegations that this Court has repeatedly rejected, and that the PSLRA was designed to weed out. Specifically, the Complaint seeks to infer scienter based on little more than that Image made accounting errors, which found their way into SOURCECORP's financial statements, and Bowman and Edwards were in charge of SOURCECORP at the time. Simply put, Plaintiffs posit a collective

knowledge at SOURCECORP of the accounting problems at Image, and presume Bowman's and Edwards' knowledge based on their positions in the company – a view that would impose something very close to strict liability on corporate officers. The law, however, is to the contrary. In similar circumstances, this Court in *Abrams* made clear that plaintiffs generally cannot establish a strong inference of scienter without identifying "specific internal or external report[s]" or other specific information that the defendants possessed and that contradicted the allegedly false statements. 292 F.3d at 432. The Complaint here fails to identify *any* such contradictory information, let alone enough to give rise to a strong inference of fraudulent intent.

To begin with, the simple fact that Bowman is the CEO, and Edwards the CFO, of SOURCECORP cannot give rise to a strong inference of scienter. "A pleading of scienter may not rest on the inference that defendants must have been aware of the misstatement based on their positions within the company." *Abrams*, 292 F.3d at 432. Yet that is how Plaintiffs attempt to show scienter here. *See* Complaint ¶ 23, R715-17. In case after case, this Court has rejected such allegations. *See, e.g.*, *R2 Invs.*, 401 F.3d at 646 ("[w]e will not . . . attribute knowledge . . . based solely on the positions of the defendants"); *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 868 (5th Cir. 2003) ("pleading of scienter may not rest on . . . their positions within the company" (quoting *Abrams*, 292 F.3d at 432)); *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994) (scienter was not adequately pleaded based on allegation that "[b]ecause of their board membership and/or their executive and managerial

positions with URCARCO, defendants . . . knew or had access to information concerning the adverse non-public information about URCARCO's adverse financial outlook"). Simply put, when a complaint "fails to identify exactly who supplied the information or when they knew the information," it "fall[s] far short of the who, what, when, where, and how required under 9(b) and . . . the PSLRA." *Rosenzweig*, 332 F.3d at 868 (internal quotation marks omitted)).

Accordingly, where, as here, the essence of the alleged fraud is the failure to follow Generally Accepted Accounting Principles (GAAP), "[t]he mere publication of inaccurate accounting figures or failure to follow GAAP, without more, does not establish scienter. The party must know that it is publishing materially false information, or must be severely reckless in publishing such information." *Goldstein v. MCI WorldCom*, 340 F.3d 238, 253-54 (5th Cir. 2003). Two cases applying this rule are of particular relevance here. In *Financial Acquisition Partners LP v. Blackwell*, addressing a claim of fraud based on accounting errors, this Court held that there can be no strong inference of scienter where "Plaintiffs fail to plead facts supporting an allegation that any Defendant knew the value of [the company's] assets was overstated." 440 F.3d at 289. Similarly, in *Goldstein*, another accounting fraud case, this Court upheld the dismissal of the complaint, reasoning that, in the absence of specific facts showing knowledge, "the complaint here presents what could best be described as allegations of mismanagement . . . by several individuals in charge of

handling the accounts rather than severe recklessness by [the CEO and CFO]." 340 F.3d at 254.

Here, as in *Blackwell* and *Goldstein*, Plaintiffs attempt to divine scienter from the existence of errors in the recording of revenue and expenses, but provide no allegations showing how or when Bowman and Edwards knew that revenue was recorded improperly and expenses were shifted to another company. *See id.* at 251 (the complaint "fails to connect [the CEO or CFO] to the write-off procedure in a manner that demonstrates involvement in the initiation of write-offs"). This case is thus a textbook example of what this Court has plainly rejected: generalized allegations of scienter based on accounting problems without any specific link to the individual defendants.

Abrams, which, like this case, involved alleged accounting errors at a subsidiary, is even more closely on point. In *Abrams*, a subsidiary committed accounting errors related to accounts receivable, inventory, and employee compensation, and the plaintiffs alleged that the officers of the parent company must have known of these errors. 292 F.3d at 429. This Court rejected that conclusory allegation, holding that because the "plaintiffs have not pointed to any *particular* reports or information—available to defendants before the announced financial restatements—that are contrary to the restatements," there could be no strong inference of scienter. *Id.* at 433 (emphasis added). Similarly, in *ABC Arbitrage Plaintiffs Group v. Tchuruk*, this Court held an allegation that a parent company knew of huge losses of the subsidiary

based on unidentified "regular reports" is insufficient for scienter. 291 F.3d 336, 358 (5th Cir. 2002). Other circuits have also routinely rejected claims based on a parent company's presumed knowledge of accounting errors at a subsidiary. *See Ezra Charitable Trust v. Tyco Int'l, Ltd.*, 466 F.3d 1, 9 (1st Cir. 2006); *Kushner v. Beverly Enters., Inc.*, 317 F.3d 820, 829 (8th Cir. 2003); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 554 (6th Cir. 1999); *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 270 (2d Cir. 1996).

Despite this overwhelming case law, Plaintiffs, citing *Nathenson* and *Plotkin v. IP Axess Inc.*, 407 F.3d 690 (5th Cir. 2005), argue that scienter can be shown even in the absence of specific factual allegations demonstrating the defendants' knowledge. *See* Appellants' Br. at 28, 32-33. *Nathenson*, however, actually *reaffirms* the rule that "normally an officer's position with a company does *not* suffice to create an inference of scienter," and finds an exception to that rule only because of the presence of "a number of special circumstances" making clear that the CEO in that case had to have known the facts at issue – in particular, the circumstance that the fraud concerned basic elements of the patent protection that was critical to the company's only product. 267 F.3d at 424-25 (emphasis added). In *Plotkin*, similarly, the corporation could be presumed to know basic information casting doubt on the reliability of the business partner to which it claimed to expect to make the overwhelming majority of its sales, *i.e.*, that this purported partner had only $7 million in revenue and had been incorporated for only six months. 407 F.3d at 699-700. No such "special circumstances" are present here, where the fraud concerned specific accounting

calculations at one of SOURCECORP's many subsidiaries, and involved just 1.2% of SOURCECORP's revenues and 0.4% of its expenses. Indeed, the notable "special circumstance" here cuts in precisely the opposite direction – the Complaint makes clear that the truth was intentionally hidden from these defendants.

Accordingly, Plaintiffs cannot escape the need to allege specific information known to Bowman or Edwards that was inconsistent with SOURCECORP's public statements. Such information, however, is almost entirely lacking. There is no allegation of any improper accounting directed by Bowman or Edwards, and Plaintiffs' "confidential-witness" statements consist largely of assertions about purported collective knowledge at SOURCECORP that is not linked to Bowman or Edwards. *See* Complaint ¶ 23, R715-17. As the District Court recognized, *see* Amended Order at 7, R1720, Plaintiffs are able to muster only a single allegation specific to a particular defendant: that during the "first few days of 2003," Edwards, the CFO, told a Regional Controller that SOURCECORP "was changing its revenue-recognition policy for work-in-progress receivables because some SOURCECORP subsidiaries did not have contracts to substantiate their revenues." Complaint ¶ 23, R716 (emphasis omitted). Plaintiffs allege that this contradicts statements that "SOURCECORP subsidiaries recognized revenue only when they possessed documentation." *Id.* ¶ 4, R708.

The District Court cogently explained why this allegation cannot aid Plaintiffs. *See* Amended Order at 7-8, R1720-21. As an initial matter, Plaintiffs, to establish

scienter, must show that Edwards had knowledge that contradicted his public statements *at or before the time the statements were made.* Yet the alleged misstatements about documentation of which Plaintiffs complain occurred only "from the beginning of the Class Period until early 2003." Complaint ¶ 4, R708. Edwards' alleged conversation in the "first few days of 2003" cannot show that *previous* statements about documentation were knowingly or recklessly false.

In addition, the only reasonable interpretation of the alleged conversation is that Edwards, having learned of a problem, was acting to correct it, *not* that he was knowingly ignoring the issue and lying about its existence. *See* Amended Order at 7-8, R1720-21. There is nothing about the statement that suggests Edwards intended to make or sign statements inconsistent with what he had learned, and therefore no basis for any inference, let alone a strong inference, of fraudulent intent.

Furthermore, the Complaint alleges no connection between Edwards' alleged knowledge of a documentation issue at "some SOURCECORP subsidiaries" and the accounting fraud from which plaintiffs claim damage – *i.e.*, there is no allegation that any part of the fraud or restatement, let alone a material part, resulted from lack of documentation. To the contrary, Plaintiffs allege that the accounting inaccuracies resulted from *different* problems, such as recognizing revenue "prior to delivering contractually required output" and "in excess of the volume and/or revenue limits set by the contract." Complaint ¶ 38, R720-21; *see also id.* ¶ 110, R739-40 (Image recorded revenue before delivering products to the customer, recorded revenue for excess

product delivered, and improperly shifted expenses to entities controlled by some person or persons in the management of the subsidiary). Nor, for that matter, does the Complaint even allege facts to show that Edwards' remark was referring to Image, rather than other subsidiaries. In short, there are a host of reasons why Edwards' alleged comment provides no support for Plaintiffs' scienter allegations.

As that comment is the only particularized allegation specific to Bowman or Edwards, Plaintiffs, like the plaintiffs in *Abrams*, are left with no "internal or external report available at the time of the alleged misstatements," and no other particularized allegations, to suggest that Bowman or Edwards knew of the subsidiary's accounting errors. Indeed, the Complaint itself suggests that only Deaton had any knowledge of the accounting errors, and because he was attempting to defraud SOURCECORP, he had every incentive to keep his actions hidden from the parent company. Plaintiffs therefore cannot show that the truth about Image's accounting was "either known to the defendant[s] or is so obvious that the defendant[s] must have been aware of it." *Nathenson*, 267 F.3d at 408 (internal quotation marks omitted). Plaintiffs' attempt to assume this knowledge is in direct opposition to this Court's precedents.

Nor can Plaintiffs cure this complete absence of a basis for an inference of fraud by arguing that Bowman's and Edwards' certification of SOURCECORP's internal controls (rather than their reporting of financial results) was fraudulent. This issue, too, was addressed in *Abrams*, which affirmed the dismissal of a claim that "the defendants deceived the investing public regarding the adequacy of Baker Hughes'

internal financial controls." 292 F.3d at 427; *see also id.* at 428 (plaintiffs allege that "internal controls were inadequate and unreliable but the defendants repeatedly touted the adequacy of the company's internal controls"). The same requirements that are fatal to Plaintiffs' claim based on accounting errors apply (and are fatal) to their internal controls claim: the plaintiffs must point to particular "allegations that the defendants knew about the internal control problems," and cannot rest on the premise "that they should have known or that their lack of knowledge based on their corporate positions demonstrates recklessness." *Id.* at 432.

Here, in language strikingly similar to the language used in the *Abrams* complaint, Plaintiffs fall back on the same unacceptable assumption that the defendants knew the controls were inadequate simply based on the defendants' positions and an alleged lack of oversight. *Compare id.* at 427-28 ("Years of growth through mergers and acquisitions had left [the parent company's] accounting systems in disarray, with no unified accounting system and a lack of proper internal controls."), *and id.* at 432 ("the company lacked a single uniform accounting system and thus knew that the company's internal controls lacked cohesiveness"), *with* Complaint ¶ 23, R716 ("SOURCECORP allowed its subsidiaries to 'do their own thing' on reporting financial performance" and "each subsidiary used a different accounting system"). Despite broad rhetoric about the alleged inadequacy of SOURCECORP's controls, Plaintiffs identify only a single specific purported inaccuracy: that SOURCECORP relied on the independent internal controls of its subsidiaries, rather than a centralized

internal control and audit system. *See id.*, R716. The courts that have addressed this issue, however, have consistently rejected the argument that a parent company's reliance on subsidiaries to perform their accounting correctly shows scienter. *See Abrams*, 292 F.3d at 431-33; *see also In re Comshare*, 183 F.3d at 554 ("this Court should not presume recklessness or intentional misconduct from a parent corporation's reliance on its subsidiary's internal controls"); *Chill*, 101 F.3d at 271 ("intentional misconduct or recklessness cannot be presumed from a parent's reliance on its subsidiary's internal controls" (internal quotation marks omitted)); *Ezra*, 466 F.3d at 10 (citing *Chill*, 101 F.3d at 271). In short, Plaintiffs are no more able to allege facts establishing a strong inference that the defendants knew or "must have been aware," *Nathenson*, 267 F.3d at 408, of internal control problems than they are with respect to the alleged accounting misstatements.

B. Plaintiffs' Failure To Allege Any Rational Motive For Bowman, Edwards, Or SOURCECORP To Commit The Fraud Further Demonstrates The Lack Of A Strong Inference Of Scienter.

Even aside from the complete absence of particularized allegations supporting scienter, the Complaint's scienter allegations are further undermined by Plaintiffs' inability to provide any coherent theory of why Bowman, Edwards, or SOURCECORP would have committed such a fraud. Where the plaintiffs fail to show the defendants' motive for the fraud, they face a "more stringent standard" for establishing scienter. *Melder*, 27 F.3d at 1102; *see R2 Invs.*, 401 F.3d at 644 ("Where, as here, the plaintiff has not alleged a clear motive for the alleged misstatements or

omissions, the strength of its circumstantial evidence of scienter must be correspondingly greater."); *ABC Arbitrage*, 291 F.3d at 350 (the plaintiff must "plead with particularity what the person making the misrepresentation obtained thereby").

In the instant case, there is no allegation of a benefit from the fraud that accrued to Bowman, Edwards, or SOURCECORP; in fact, the fraud harmed all of them. Specifically, Plaintiffs do not make insider-trading allegations against Bowman or Edwards, and do not otherwise suggest any motive for them to commit the fraud. Indeed, the fact that Bowman and Edwards owned significant amounts of SOURCECORP stock, *see* Complaint ¶ 15(a), R711 (in April 2003, Bowman held 524,625 shares and had "exerciseable warrants" for 492,025 additional shares), ¶ 15(b), R711 (Edwards held 38,500 shares and had "exerciseable warrants" for 27,500 shares), yet are not alleged to have made any suspicious sales, affirmatively undermines an inference of scienter. *See Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) ("The fact that the other defendants did not sell their shares during the relevant class period undermines plaintiffs' claim that defendants delayed notifying the public so that they could sell their stock at a huge profit." (internal quotation marks omitted)); *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1425 (9th Cir. 1994) ("the Officers' minimal sales of stock [given their large holdings] also negates an inference of scienter"); *Morse v. McWhorter*, 200 F. Supp. 2d 853, 897 (M.D. Tenn. 2000), *vacated on other grounds*, 290 F.3d 795 (6th Cir. 2002) ("Such retainage of substantial stock undermines 'suspicion' of fraud.").

Similarly, the fraud plainly hurt SOURCECORP because the company paid out $15.8 million to Deaton (and other former Image shareholders) it should not have paid. In addition, it repurchased huge quantities of its stock at the supposedly inflated stock price. *See* Complaint ¶ 63, R727 (noting that in 2003, SOURCECORP repurchased 1,306,979 shares of its stock at a cost of approximately $20.7 million); App. F to Defendants' Motion to Dismiss at 147 (SOURCECORP Form 10-Q for 3Q2004, stating that SOURCECORP repurchased an additional 396,215 shares for approximately $10.1 million). These actions are incompatible with the idea that the corporation knew of the fraud. *See, e.g., In re Tibco Software, Inc.*, No. C 05-2146, 2006 WL 1469654, at *21 (N.D. Cal. May 25, 2006) ("stock repurchase programs actually negate a finding of scienter"); *Morse*, 200 F. Supp. 2d at 898 (M.D. Tenn. 2000) ("A company's decision to reinvest its own stock undermines an inference of scienter because it presumably would make no sense to purchase that stock if defendants knew the prices to be inflated." (internal quotation marks omitted)); *In re Rexall Sundown, Inc. Sec. Litig.*, No. 988798CIVDIMITROULEA, 2000 WL 33539428, at *4 (S.D. Fla. Mar. 29, 2000) ("a corporation buying back its stock would not do so if it had been engaged in artificially pumping up that stock").

The lack of motive here is further evidenced by SOURCECORP's release of information about the accounting errors without any alleged provocation. The Complaint does not suggest that anyone outside the company was about to discover the errors. It also does not attempt to explain why Bowman or Edwards would

decide to reveal the fraud now after knowing the truth for so long. SOURCECORP's revelation of the accounting problems therefore provides yet another indication that Bowman and Edwards had no reason to allow the accounting errors to continue once they knew of their existence. *See Albert Fadem Trust v. Am. Elec. Power Co.*, 334 F. Supp. 2d 985, 1014 (S.D. Ohio 2004) ("The most plausible inference from AEP's public disclosure is *not* that Defendants acted recklessly in not knowing about the inaccurate reporting before the announcement. Rather, the most plausible of the competing inferences is that Defendants acted diligently in remedying a problem as soon as they became aware of the possibility that it existed and did not try to hide it from AEP investors.").

In short, the Complaint's account of the fraud simply does not add up because Bowman, Edwards, and SOURCECORP were harmed by the very fraud they supposedly perpetrated. This lack of a coherent explanation for the fraud undercuts the allegation of fraudulent intent. *See Melder*, 27 F.3d at 1104 n.10 (holding scienter was not adequately pleaded in part because of the "irrationality" of the plaintiffs' theory of the fraud); *Coates v. Heartland Wireless Communications, Inc.*, 55 F. Supp. 2d 628, 643 (N.D. Tex. 1999) (a theory of the defendants' motive that "defies common sense . . . does not give rise to a strong inference of fraud"). Thus, Plaintiffs cannot turn Deaton's swindling of SOURCECORP into a fraud by SOURCECORP without any specific allegations that anyone at SOURCECORP knew of or benefited from the fraud.

C. Plaintiffs' Efforts To Invent An Exception To This Court's Rule Against Generalized Allegations Are Unavailing.

In the absence of any specific allegations supporting defendants' scienter, Plaintiffs offer up a variety of arguments in favor of treating their conclusory allegations differently from those rejected in *Abrams*, *ABC Arbitrage*, and the other cases previously discussed. None of these arguments has merit.

First, Plaintiffs argue that the size of the alleged fraud is sufficient to presume scienter. *See* Appellants' Br. at 37-38. As an initial matter, this Court has expressly rejected the argument that the magnitude of a restatement alone can suffice to show scienter. *See Goldstein*, 340 F.3d at 251 ("Bare conclusory allegations that [the CEO and CFO] must have known about the accounts receivable problem simply because a large write-off was made [$685 million, 62% of the total reserves balance and 28% of net income], at least in the case of a company of this magnitude, will not suffice under the PSLRA."). Simply put, even a large accounting error is not necessarily an apparent one, so courts cannot assume, in the absence of further allegations, that the defendants must have been aware of it. *See Chill*, 101 F.3d at 270 ("The plaintiffs do not demonstrate how the increased level of activity at [the subsidiary], as reflected in GE's consolidated financial records, would necessarily have indicated to GE that there was misconduct. The fact that GE did not automatically equate record profits with misconduct cannot be said to be reckless."); *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990) ("Four billion dollars is a big number, but even a large

column of big numbers need not add up to fraud."). Indeed, the monetary loss from the frauds at issue in *Abrams* and *ABC Arbitrage* were very significant, and yet still did not satisfy the strong-inference standard. *See Abrams*, 292 F.3d at 428-29, 432 (restatement reduced profit by $31 million, and concerned fraud at a subsidiary that produced 20% of the company's revenue); *ABC Arbitrage*, 291 F.3d at 358 (fraud concerned subsidiary's allegedly unreported losses of 400 million francs, which was approximately $70 million at the time); *see also Chill*, 101 F.3d at 265 (restatement of $350 million for subsidiary's accounting fraud).[6]

In any event, there is no support for Plaintiffs' assertion that the size of the fraud here was so great that Bowman or Edwards must have been aware of it. The Complaint does not allege that the particular numbers coming from Image were suspicious at all. Moreover, the errors were tiny compared to SOURCECORP's overall figures, with a restatement of revenue of only 1.2% and expenses of only 0.4%. *See* Complaint ¶ 119, R743. The relative insignificance of these figures belies the notion that the fraud must have been apparent simply from its size. *See In re AFC Enters., Inc. Sec. Litig.*, 348 F. Supp. 2d 1363, 1372 & n.3 (N.D. Ga. 2004) (holding that

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[6] The district court cases Plaintiffs cite, *see In re Elec. Data Sys. Corp. Sec. & ERISA Litig.*, 298 F. Supp. 2d 544, 557 (E.D. Tex. 2004); *In re Triton Energy Ltd. Sec. Litig.*, No. 5:98-CV-256, 2001 WL 872019 (E.D. Tex. Mar. 30, 2001), offer no support for the proposition that the magnitude of a fraud, in the absence of allegations satisfying this Court's cases like *Abrams* and *ABC Arbitrage*, can establish scienter. The allegations in *In re Electronic Data Systems* included specific meetings and reports where the defendants "were made actually aware" of the facts. 298 F. Supp. 2d at 557. And *In re Triton*, like *Nathenson*, involved basic falsities concerning the company's most important assets. 2001 WL 872019, at *10-*11.

income overstatements of 50% and 136% would not have been obvious, and therefore do not show scienter, when they reflected differences in revenues and expenses of less than 5%). Even looking solely at the revenue and expense adjustments' ultimate effect on income – a misleadingly narrow focus – only $18.1 million of that $33.9 million effect could be found in Image's misstatements,[7] an amount that is much less than the amounts at issue in *Abrams* and *ABC Arbitrage*. In sum, the amount of these errors does nothing to show that Bowman or Edwards must have known the figures to be erroneous at the time the financial statements were issued.

Second, Plaintiffs argue that the existence of an earn-out provision requires a heightened duty to monitor the subsidiary's accounting. *See* Appellants' Br. at 30. As Plaintiffs neither pleaded this allegation in the Complaint nor raised this argument in the district court, *see* Opposition to Motion to Dismiss, R768, it should not be considered now. *See Cutrera v. Bd. of Supervisors of La. State Univ.*, 429 F.3d 108, 113 (5th Cir. 2005) ("Appellant's new factual theory was not raised in her complaint, nor raised in her opposition to Appellee's motion for summary judgment. We decline to consider Appellant's new arguments raised for the first time on appeal."). In any event, this argument has no merit. Plaintiffs cite no precedent for it, and the only case

[7] The remaining $15.8 million came from earn-out overpayments that compounded the error. Plaintiffs do not explain how these overpayments can support scienter, and indeed it would be absurd to treat them as evidence of scienter since they harmed, rather than benefited, SOURCECORP, and there is no allegation that the payments were not correctly made given the figures from Image.

of which we are aware on the issue expressly rejects it. *See In re Stonepath Group, Inc. Sec. Litig.*, No. Civ. A. 04-4515, 2006 WL 890767, at *16 (E.D. Pa. Apr. 3, 2006). Just as in *Stonepath*, Plaintiffs do not allege that the earn-out provision applied to the subsidiary's financial officers, so the fact that its CEO had incentives for reaching certain revenue goals did not create a suspicion that the subsidiary's financial reporting would be fraudulent. Moreover, Deaton's incentive to produce good results for purposes of the earn-out provision cannot be meaningfully distinguished from numerous other financial incentives to produce such results, and the courts have regularly rejected the argument that such incentives can support an inference of scienter. *See, e.g., Nathenson*, 267 F.3d at 420.

Third, Plaintiffs argue that the Sarbanes-Oxley certifications signed by Bowman and Edwards are sufficient to support scienter. *See* Appellants' Br. at 30-35. However, the lone court of appeals to consider the issue held that such certifications are probative of scienter only if the certifications themselves were signed with severe recklessness as to their falsity. *See Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1266 (11th Cir. 2006). In other words, if the defendants do not know the certification to be false, then the fact of its falsity does not show anything about the defendants' mental state. If the law were otherwise, the certifications would become a tool for reducing the scienter requirement, and as *Garfield* explains, "[t]he plain meaning of the language contained in Sarbanes-Oxley, 18 U.S.C. § 1350, does not indicate any intent to change the requirements for pleading scienter set forth in the PSLRA." *Id.* While *Abrams* did

not expressly decide this issue, it seems to follow the same approach as *Garfield*. Specifically, after noting that there was no scienter as to the verifications themselves, the Court did not mention defendants' verifications of internal financial controls as supporting scienter as to other aspects of the financial statements. *See* 292 F.3d at 432-34. Applying the *Garfield* rule here, the certifications are irrelevant. As explained above, Plaintiffs have not adequately alleged that Bowman or Edwards knew the certifications of the accounting figures and internal controls to be false. This fact shows that the only case cited by Plaintiffs on this point is inapposite, because in that case the defendants knew of internal control problems. *See In re OCA, Inc. Sec. & Derivative Litig.*, No. 05-2165, 2006 WL 3747560, at *22 (E.D. La. Dec. 14, 2006).

Even if the certifications were relevant here, they would provide at most only a trivial indication of scienter. While district courts vary in their use of Sarbanes-Oxley certifications for scienter purposes, none considers them more than a secondary factor in the analysis, and most have held the strong-inference requirement was not satisfied despite the certifications. *See, e.g.*, *In re ConAgra Foods, Inc. Sec. Litig.*, No. 8:05CV292 *et al.*, 2006 WL 3247199, at *3-*4 (D. Neb. Sept. 19, 2006); *Ley v. Visteon Corp.*, No. 05-CV-70737-DT, 2006 WL 2559795, at *9 (E.D. Mich. Aug. 31, 2006); *Zucco Partners, LLC v. Digimarc Corp.*, 445 F. Supp. 2d 1201, 1209 (D. Or. 2006); *In re Bally Total Fitness Sec. Litig.*, No. 04 C 3530 *et al.*, 2006 WL 3714708, at *8 (N.D. Ill. July 12, 2006); *In re Watchguard Sec. Litig.*, No. MASTER FILE C05-678J, 2006 WL 2038656, at *10-*11 (W.D. Wash. Apr. 21, 2006); *In re Invision Techs., Inc. Sec. Litig.*, No.

C04-03181, 2006 WL 538752, at *7 n.3 (N.D. Cal. Jan. 24, 2006). Indeed, if the certifications were themselves sufficient for scienter, it would create strict liability for the corporate officers making the certifications, in direct opposition to the long-established scienter requirement.

In sum, all of Plaintiffs' arguments for excusing the Complaint's lack of specific factual allegations are entirely unavailing.

D. The District Court Properly Considered The Allegations In The Complaint *In Toto* In Concluding That There Was No Strong Inference Of Scienter.

Plaintiffs' repeated protestation that the District Court did not consider their allegations *in toto*, *see* Appellants' Br. at 29-30, is completely without basis. The District Court expressly stated that it *did* consider all of Plaintiffs' allegations together, and that those allegations were *collectively* insufficient: "[T]his Court must consider scienter allegations collectively. *Barrie v. Intervoice-Brite, Inc.*, 397 F.3d 249, 261 (5th Cir. 2005). That said, the Complaint did not plead facts collectively giving rise to a strong inference of scienter on the part of Bowman or Edwards." Amended Order at 8, R1721. This explanation plainly suffices to show that the District Court conducted the proper analysis. *See Abrams*, 292 F.3d at 431 ("The district court's clear statement that it considered the allegations insufficient in the aggregate . . . is difficult for us to contradict."). In addition, the District Court examined all of the major arguments Plaintiffs put forward on the scienter issue. *See* Amended Order at 5-9, R1718-22. Indeed, the argument that Plaintiffs now emphasize as showing the inattention of the

District Court – the relationship between the earn-out provision and scienter – was not even mentioned by Plaintiffs below. In sum, the District Court correctly held that Plaintiffs' allegations, considered separately or together, do not give rise to a strong inference of scienter.

II. THE DISTRICT COURT CORRECTLY HELD THAT PLAINTIFFS FAILED TO STATE A CLAIM AGAINST IMAGE.

The District Court's judgment in favor of Image should also be affirmed. Plaintiffs' claim against Image is simply an attempt at an end run around the deficiencies in their claims against SOURCECORP, and it fails on two independent grounds. First, as a recent decision of this Court makes clear, since Image did not make the allegedly false statements upon which Plaintiffs purportedly relied, Image cannot be liable under Section 10(b). Second, Plaintiffs failed to allege particularized facts supporting a strong inference of scienter against Image. Plaintiffs allege Image's scienter based solely on imputation to Image of Deaton's scienter, but, because Deaton was acting adversely to Image, his knowledge cannot be imputed to it.

A. Image Cannot Be Held Liable Under Section 10(b) Because It Did Not Make The Alleged Misstatements Upon Which Plaintiffs Supposedly Relied.

Image is not liable under Section 10(b) because it did not make the allegedly false financial statements. This Court's opinion in *Regents*, 2007 WL 816518, makes clear that Section 10(b) liability only extends to those who make the misstatements or

breach a duty of disclosure *themselves*.[8] Since the Complaint alleges no public statements by Image, Plaintiffs have failed to state a claim against Image.

In *Regents*, the plaintiffs brought Rule 10b-5(a) and 10b-5(c) claims against banks that allegedly entered into partnerships and transactions with Enron Corporation that they allegedly knew would enable Enron to misstate its financial condition.[9] *Id.* at *1-*2. *Regents* recognized that Rule 10b-5 liability – under any subsection of Rule 10b-5 – cannot go beyond the bounds of the "deceptive" or "manipulative" acts prohibited by Section 10(b) of the 1934 Act. *See id.* at *12 n.32 (citing *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 173 (1994)). Further, the definitions of these words, as explained in several Supreme Court cases, have strict boundaries. "'[D]eceptive' conduct involves either a misstatement or a failure to disclose by one who has a duty to disclose." *Id.* at *10 (internal quotation marks omitted); *see also id.* at *12 ("a device, such as a scheme, is not 'deceptive' unless

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[8] Although the District Court rejected this argument, that decision was rendered before this Court's decision in *Regents*. It is also worth noting that the Supreme Court recently granted certiorari on this issue in *In re Charter Communications, Inc., Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006), *cert. granted sub nom. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, --- S. Ct. ---, 2007 WL 879583 (Mar. 26, 2007).

[9] Rule 10b-5 states: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5.

it involves breach of some duty of candid disclosure"). "Manipulation requires that a defendant act directly in the market for the relevant security." *Id.* at *13. The banks fit neither definition because they did not make the misstatements at issue and owed no duty to Enron shareholders, *id.* at *12, and their deals with Enron were not direct actions in the market for Enron securities, *id.* at *14.

Applying the reasoning in *Regents*, Image is not liable under Section 10(b). Plaintiffs' claims against Image, like the claims in *Regents*, are brought under Rule 10b-5(a) and 10b-5(c) for alleged participation in a fraudulent scheme. *See* Complaint ¶¶ 6, 110, 124(b), R708, 740, 745. And as in *Regents*, Image neither made a public misstatement nor breached any duty of disclosure. SOURCECORP, not Image, had the duty to shareholders to issue accurate financial statements and only SOURCECORP made the allegedly fraudulent statements supposedly relied on by Plaintiffs.[10] It does not matter that through Deaton's malfeasance Image allegedly *assisted* SOURCECORP in the preparation of SOURCECORP's financial statements. The banks in *Regents* similarly "aided and abetted Enron's deceit by making its misrepresentations more plausible"; this is insufficient for primary liability under Section 10(b) regardless of the purpose or effect of the actions. 2007 WL 816518, at *12; *see also Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 155 (2d Cir. 2007) (holding accountant not liable under Section 10(b) for its review and approval of

[10] It is plain that Image's actions also do not qualify as "manipulative" acts since there is no allegation of direct interference with the securities market. *See Regents*, 2007 WL 816518, at *13-*14.

fraudulent financial statements because the "[p]ublic understanding that an accountant is at work behind the scenes does not create an exception to the requirement that an actionable misstatement be made by the accountant"). Indeed, imposing liability on Image would contradict *Central Bank*'s holding that there is no aiding and abetting liability under Section 10(b). *See* 511 U.S. at 180; *see also id.* at 191 (secondary liability is available only when the defendant "makes a material misstatement (or omission) on which a purchaser or seller of securities relies"). Here, Plaintiffs have made no such showing of reliance on Image's statements or actions, instead alleging reliance only on SOURCECORP's misstatements.

Moreover, this Court's decision in *Kaplan*, 9 F.3d 405, is directly on point, in that *Kaplan* established that subsidiaries are not liable under Section 10(b) for the misstatements of the parent company, even where the financial statements of the parent were misstated because of fraud at the subsidiary. Specifically, *Kaplan* held that "Petersen, Marquez, and Stegall[, officers of Aquila, a wholly owned subsidiary of Utilicorp,] could not be held liable for making false statements to [the plaintiff] because they were not responsible for the Utilicorp financial statements, which are the subject of this action." *Id.* at 407; *see also Lindblom v. Mobile Telecomms. Techs.*, 985 F. Supp. 161, 163 (D.D.C. 1997) ("A wholly owned corporate subsidiary of a corporate parent is not liable for the deceitful statements of its parent corporation."). This case is on all fours with *Kaplan*, as Plaintiffs argue that the subsidiary, Image, is liable based on the alleged misstatements of the parent, SOURCECORP. Nor can *Kaplan* be

distinguished on the basis that Image caused the errors in SOURCECORP's financial statements, since the subsidiary's officers in *Kaplan* likewise caused the errors through their misappropriation of funds. Accordingly, Plaintiffs simply cannot state a Section 10(b) claim against Image based on alleged misstatements by SOURCECORP.

In sum, since Image did not make the make the allegedly false financial statements, Plaintiffs have failed to state a Section 10(b) claim against Image.

B. Plaintiffs Failed To Establish A Strong Inference Of Scienter Against Image Because, As Deaton Was Acting Adversely To Image, His Knowledge Cannot Be Imputed To It.

The District Court correctly rejected Plaintiffs' claim to have established scienter on the part of Image based solely on the scienter of Deaton. Since Deaton was acting in his own interests, not in the interests of Image, his knowledge cannot be imputed to Image. This Court examined the issue of imputing knowledge to the corporation in *Kaplan*, a case that Plaintiffs simply ignore. The *Kaplan* plaintiffs brought a Rule 10b-5 claim against a corporation based on the misappropriation of funds by its employees. This Court held that the employer was not liable under Rule 10b-5 because "the knowledge and actions of employees acting adversely to the corporate employer cannot be imputed to the corporation." *Kaplan*, 9 F.3d at 407.[11] It is well established that an employee is considered to be acting adversely to the

[11] This holding is perfectly consistent with *Southland*, which Plaintiffs cite for the general proposition that the employee's scienter determines the employer's scienter. *See* Appellants' Br. at 42-48. There was no issue in *Southland* regarding the possible adverse interests of the employee. Moreover, *Southland* recognized that it could consider the employee's actions as the employer's because his "actions were intended to benefit" the company. 365 F.3d at 365.

company, thereby disallowing the imputation of knowledge to the company, where he acts "entirely for his own or another's purposes." *FDIC v. Shrader & York*, 991 F.2d 216, 224 (5th Cir. 1993) (quoting Restatement (2d) of Agency § 282(1) (1957)).

The allegations in the Complaint make clear that Deaton was acting adversely to Image. Just like the employee's misappropriation of funds in *Kaplan*, Deaton committed the alleged fraud to receive the $25 million earn-out bonus, effectively to steal from SOURCECORP, not to raise SOURCECORP's stock price. Moreover, no benefit accrued to Image because it had no publicly traded stock to inflate and did not share in the undeserved earn-out payments.

Plaintiffs argue that the District Court conducted improper factfinding in deciding this issue. *See* Appellants' Br. at 44. Plaintiffs, however, ignore the allegations of their own Complaint. Paragraph 6 of the Complaint spells out that the lone motivation belonged to Deaton, and the fraud was conducted "with one aim in mind: that Deaton would collect $25 million from SOURCECORP." Complaint ¶ 6, R708; *see also id.* ¶ 111, R740 ("Deaton and Image intentionally overstated revenues and understated expenses to ensure that he hit the earnings targets necessary to receive his $25 million earn-out."). Thus, by Plaintiffs' own allegations, Deaton was acting "entirely for his own . . . purposes," *Shrader & York*, 991 F.2d at 224, in committing the fraud, and his knowledge cannot be imputed to Image.

Plaintiffs now suggest that Image benefited from SOURCECORP's artificially inflated share price simply because it is a subsidiary of SOURCECORP, and

specifically because SOURCECORP could provide additional resources to Image. *See* Appellants' Br. at 44 nn. 10, 11. As an initial matter, since Plaintiffs did not make any such allegations in the Complaint and did not raise this argument before the District Court, these allegations cannot be put forward here. *See, e.g.*, *Blackwell*, 440 F.3d at 289 ("Needless to say, in reviewing a Rule 12(b)(6) dismissal, we review only the well-pleaded facts in the complaint. This new allegation may *not* be considered."). In any event, the test is whether the employee *intended* to benefit the company, *see Shrader & York*, 991 F.2d at 224, not whether the company happened to receive some tangential benefit. Furthermore, even on their own terms, Plaintiffs' allegations fail. Plaintiffs provide no basis for their claim that Image would receive additional resources. And Plaintiffs' claim that a subsidiary's interests are identical to its parent's interests actually cuts *against* Plaintiffs: there can be no doubt that Deaton's actions, which were aimed at defrauding SOURCECORP, were contrary to SOURCECORP's interests.

Finally, the issue was appropriately decided on a motion to dismiss. In *Kaplan*, this Court decided the issue at the motion-to-dismiss stage of the litigation.[12] 9 F.3d at 407; *see also Zurich Capital Mkts. Inc. v. Coglianese*, 332 F. Supp. 2d 1087, 1108 (N.D. Ill. 2004); *Johnson v. Tellabs, Inc.*, 262 F. Supp. 2d 937, 957 (N.D. Ill. 2003). This makes

[12] Although *Kaplan* decided the issue in a section entitled "Standing," the holding on standing was essentially a holding on failure to state a claim. *See* 9 F.3d at 407. In any event, however categorized, the Court decided the question based on the pleadings, at the motion-to-dismiss stage. *See id.*

sense, because Rule 9(b) and the PSLRA require courts to assess, *at the pleading stage*, whether the complaint's allegations create a strong inference of scienter. Where scienter is predicated upon the imputation of employee's knowledge, the court necessarily must address whether the complaint's allegations create a strong inference in favor of such imputation, *i.e.*, there must be particularized allegations showing that the employee was acting for the benefit of, and not adversely to, his employer. *See United States ex rel. Williams v. Bell Helicopter Textron Inc.*, 417 F.3d 450, 454 (5th Cir. 2005) (complaint fails to meet the particularity requirement of Rule 9(b) where it "fails to plead any particular facts showing that [the corporate defendant] was aware of the actions of its employees"). This is not, as Plaintiffs claim, improper fact finding, but rather simply application of the "strong inference" requirement of the PSLRA. The only Fifth Circuit case Plaintiffs cite on this point, *Bodin v. Vagshenian*, 462 F.3d 481 (5th Cir. 2006), is inapposite because it is not a securities fraud case and therefore did not call for the court to make the threshold "strong inference" determination.[13]

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[13] The other cases Plaintiffs cite are readily distinguishable. *See* Appellants' Br. at 43 (citing *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 100 (2d Cir. 2001); *Jackson v. John Hancock Fin. Servs. Inc.*, Civ. Action No. 04-2500-CM, *et al.*, 2006 WL 2710327, at *2 (D. Kan. Sept. 20, 2006); *In re Kidder Peabody Sec. Litig.*, 10 F. Supp. 2d 398, 417 n.17 (S.D.N.Y. 1998)). Neither *Suez Equity* nor *Jackson* concerned an employee stealing from his own company. And *Suez Equity* recognized that the plaintiff had made an "adequate allegation that [the employee] . . . was acting as defendants' agent, and in their interest, in perpetrating the alleged deception." 250 F.3d at 100. As for *In re Kidder*, it merely held that the issue would not be decided on a motion to dismiss given a dispute about the underlying facts. *See* 10 F. Supp. 2d 398, 417 n.17 ("there is a genuine dispute as to whether Jett in fact was acting adversely to Kidder's interests"). *In re Kidder* never suggested that the issue could not be decided on a motion to dismiss if the facts as alleged failed to establish a strong inference that scienter should be imputed. In any event, all of these cases are from outside the Fifth Circuit, and to the extent they could be read to say the issue should not be decided on a motion to dismiss, they are inconsistent with *Kaplan*.

Indeed, the Fifth Circuit's rejection of group pleading, *see, e.g.*, *Southland*, 365 F.3d at 364-65, exemplifies that under the Rule 9(b) and PSLRA standards a plaintiff cannot simply attribute employees' activity to the corporation. Rather, it must point to a particular employee and show that his statement was made "to further the interests of the corporation." *Id.* at 365. At the very least, there is no strong inference of scienter where, as here, the Complaint affirmatively states that the employee was acting solely in his own interests, without any suggestion of a benefit to the corporation.

III. THE DISTRICT COURT CORRECTLY HELD THAT PLAINTIFFS FAILED TO STATE A SECTION 20(a) CLAIM AGAINST BOWMAN, EDWARDS, OR SOURCECORP BECAUSE PLAINTIFFS DID NOT SUFFICIENTLY ALLEGE A PREDICATE SECTION 10(b) VIOLATION.

There must be a predicate Section 10(b) violation to state a claim under Section 20(a) for control-person liability. *See, e.g.*, *Southland*, 365 F.3d at 383 ("Control person liability is secondary only and cannot exist in the absence of a primary violation."). Plaintiffs' control-person claims against Bowman, Edwards, and SOURCECORP thus fail because Plaintiffs have not sufficiently alleged a Section 10(b) violation against any of the controlled parties.[14] Specifically, the Complaint alleges that Bowman and Edwards were control persons of

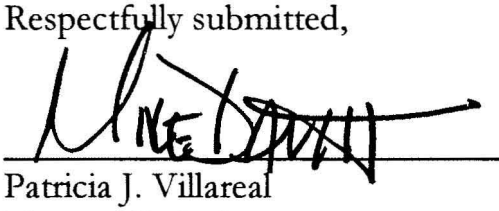
[14] While Plaintiffs quibble with the language the District Court used (*i.e.*, whether the defendants "induced or participated in Deaton's violations"), they accept the need for a predicate Section 10(b) violation. *See* Appellants' Br. at 45-46. And Deaton's alleged violation cannot serve as the predicate for Plaintiffs' Section 20(a) claims because Plaintiffs do not allege that Bowman, Edwards, or SOURCECORP was a control person of Deaton. *See* Complaint ¶¶ 134-36, R747-48. Thus, regardless of the precise language the District Court used, it correctly dismissed the Section 20(a) claims because Plaintiffs "failed to sufficiently allege a violation of section 10(b)" against a controlled person. Amended Order at 9, R1722.

SOURCECORP and Image, and that SOURCECORP was a control person of Image. *See* Complaint ¶¶ 134-36, R747-48. The Complaint does not allege that Bowman, Edwards, or SOURCECORP were control persons of Deaton. *Id.* Because Plaintiffs failed to state a Section 10(b) claim against SOURCECORP and Image, there is no Section 20(a) liability for Bowman, Edwards, or SOURCECORP.

CONCLUSION

This Court should affirm the District Court's judgment dismissing all claims against SOURCECORP, Bowman, Edwards, and Image.

Respectfully submitted,



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I hereby certify that on April 27, 2007, two true and correct copies of the foregoing Brief and a computer diskette with a copy of the foregoing Brief in Portable Document File (PDF) format were served upon each of the following by Federal Express:

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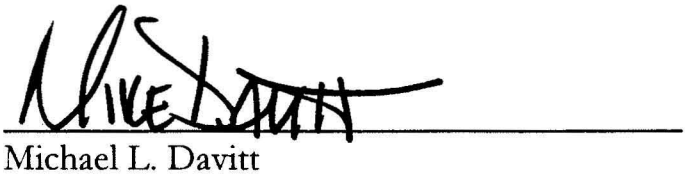

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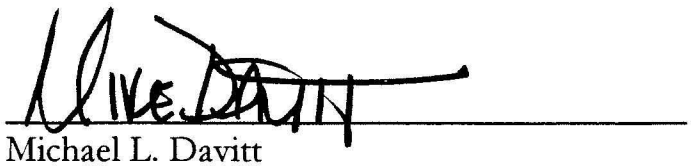

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