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UNITED STATES DISTRICT COURT  
CENTRAL DISTRICT OF CALIFORNIA

|   |   |  |
|---|---|--|
| SUSAN HUFNAGLE, individually<br>and on behalf of all others<br>similarly situated,  | ) | Case No. CV 10-08695 DDP (VBKx)  |
|   | ) |  |
| Plaintiff,  | ) |  |
| v.  | ) | <b>ORDER DENYING DEFENDANT'S MOTION<br/>TO DISMISS THIRD AMENDED<br/>COMPLAINT</b> |
|   | ) |  |
| RINO INTERNATIONAL<br>CORPORATION, DEJON ZOU,<br>JENNY LIUE, BEN WANG, LI YU,<br>KENNITH C. JOHNSON, JIANPING<br>QIU, ZIE QUAN, and ZEJIN LI, | ) | [Dkt. No. 247]   |
|   | ) |  |
| Defendants.   | ) |  |

Presently before the court is Defendant Frazer Frost, LLP ("Frazer Frost" or "the Auditor")'s Motion to Dismiss Plaintiff's Third Amended Complaint ("TAC"). Having considered the submissions of the parties, the court is inclined to deny the motion and adopt the following order.

**I. Background**

As explained in the court's earlier orders, this case is a purported class action alleging violations of the Securities Exchange Act of 1934, 15 U.S.C. § 78 et seq. (the "Exchange Act")

1 brought on behalf of a class consisting of all persons and entities  
2 who purchased publicly traded Rino International Corporation  
3 ("Rino") common stock and call options, and who sold put options of  
4 Rino, between March 31, 2009 and November 17, 2010 (the "Class  
5 Period"). The TAC alleges that RINO engaged in a wide-ranging  
6 fraud regarding its industrial equipment business in China. (TAC  
7 ¶¶ 4-5.) Plaintiff alleges, for example, that RINO grossly  
8 overstated its revenue and profits, fabricated contracts with  
9 nonexistent customers, understated its tax liabilities, and  
10 concealed transactions between RINO and other companies owned by  
11 RINO's CEO's relatives. (TAC ¶ 5.) Pursuant to a settlement  
12 agreement, Plaintiff has dismissed all claims against all  
13 Defendants, with the exception of Frazer Frost. (Dkt. No. 235.)

14 Plaintiff alleges that auditor Frazer Frost either knowingly  
15 or recklessly ignored obvious signs of financial irregularities and  
16 failed to follow generally accepted auditing standards in its  
17 review of RINO's financial statements. (TAC ¶¶ 7-25, 42-51, 133-  
18 204.) The TAC alleges that on March 31, 2010, Frazer issued false  
19 opinions regarding RINO's financial statements. Specifically,  
20 Plaintiff alleges that Frazer Frost's audit opinion regarding  
21 RINO's 2009 annual report falsely represented that RINO's financial  
22 statements conformed with generally accepted accounting principles  
23 ("GAAP"). (TAC ¶ 134.) Frazer Frost now moves to dismiss the TAC.

## 24 **II. Legal Standard**

25 A complaint will survive a motion to dismiss when it contains  
26 "sufficient factual matter, accepted as true, to state a claim to  
27 relief that is plausible on its face." Ashcroft v. Iqbal, 556 U.S.  
28 662, 678 (2009) (quoting Bell Atl. Corp. v. Twombly, 550 U.S. 544,

1 570 (2007)). When considering a Rule 12(b)(6) motion, a court must  
2 "accept as true all allegations of material fact and must construe  
3 those facts in the light most favorable to the plaintiff." Resnick  
4 v. Hayes, 213 F.3d 443, 447 (9th Cir. 2000). Although a complaint  
5 need not include "detailed factual allegations," it must offer  
6 "more than an unadorned, the-defendant-unlawfully-harmed-me  
7 accusation." Iqbal, 556 U.S. at 678. Conclusory allegations or  
8 allegations that are no more than a statement of a legal conclusion  
9 "are not entitled to the assumption of truth." Id. at 679. In  
10 other words, a pleading that merely offers "labels and  
11 conclusions," a "formulaic recitation of the elements," or "naked  
12 assertions" will not be sufficient to state a claim upon which  
13 relief can be granted. Id. at 678 (citations and internal  
14 quotation marks omitted).

15 "When there are well-pleaded factual allegations, a court should  
16 assume their veracity and then determine whether they plausibly  
17 give rise to an entitlement of relief." Id. at 679. Plaintiffs  
18 must allege "plausible grounds to infer" that their claims rise  
19 "above the speculative level." Twombly, 550 U.S. at 555.  
20 "Determining whether a complaint states a plausible claim for  
21 relief" is a "context-specific task that requires the reviewing  
22 court to draw on its judicial experience and common sense." Iqbal,  
23 556 U.S. at 679.

24 To state a claim for securities fraud under Section 10(b) of  
25 the Securities Exchange Act and Rule 10b-5 promulgated thereunder,  
26 plaintiffs must plead particularized facts demonstrating "(1) a  
27 material misrepresentation or omission of fact, (2) scienter, (3) a  
28 connection with the purchase or sale of a security, (4) transaction

1 and loss causation, and (5) economic loss." Zucco Partners, LLC v.  
2 Digimarc Corp., 552 F.3d 981, 990 (9th Cir. 2009). A complaint  
3 alleging securities fraud under the Private Securities Litigation  
4 Reform Act of 1995 ("PSLRA") must meet a heightened pleading  
5 standard. The PSLRA requires that any securities fraud claim  
6 "[s]pecify each statement alleged to have been misleading, the  
7 reason or reasons why the statement is misleading, and . . . state  
8 with particularity facts giving rise to a strong inference that the  
9 defendant acted with the required state of mind." 15 U.S.C.  
10 Section 78u-4(b)(1), (b)(2).

### 11 **III. Discussion**

#### 12 A. Scierter

13 Defendant argues that Plaintiff has failed to plead  
14 particularized facts supporting a strong inference of scierter.  
15 When analyzing a defendant's intent, courts must view complaints  
16 holistically, and should deny a motion to dismiss if the inference  
17 of scierter advanced by plaintiffs is "at least as compelling as  
18 any opposing inference one could draw from the facts alleged."  
19 Matrixx Initiatives, Inc. v. Siracusano, 141 S. Ct. 1309, 1324  
20 (2011) (citing Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551  
21 U.S. 308, 324 (2007); see also New Mexico State Investment Council  
22 v. Ernst & Young LLP, 641 F.3d 1089, 1095 (9th Cir. 2011)  
23 ("NMSIC").<sup>1</sup> In the auditing context, a plaintiff must show that  
24 "accounting practices were so deficient that the audit amounted to  
25 no audit at all, or an egregious refusal to see the obvious, or to

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26  
27 <sup>1</sup> Where any individual allegation is sufficient to create a  
28 strong inference of scierter, the court need not necessarily  
conduct a "holistic" review of the allegations in their entirety.  
NMSIC, 641 F.3d at 1095 (citing Zucco, 552 F.3d at 991-992).

1 investigate the doubtful, or that the accounting judgments which  
2 were made were such that no reasonable accountant would have made  
3 the same decisions . . . ." NMSCIC, 641 F.3d at 1098 (quotation  
4 marks and citation omitted). Allegations of a poor audit, absent  
5 intent to deceive, will not suffice. Id.

6 1. Tax returns and multiple sets of books

7 Plaintiff alleges that RINO kept two sets of corporate books,  
8 and that Frazer had actual knowledge of this improper accounting.  
9 Frazer approved RINO's report that it had \$192.6 million in revenue  
10 and a \$56.4 million profit in 2009 and \$139.3 million in revenue  
11 and \$25.5 in profit for 2008. (TAC ¶ 16.) RINO's Chinese income  
12 tax returns, however, indicated 2009 revenue of \$11.1 million and  
13 profit of \$80,000 and 2008 revenue of \$15.7 million and profit of  
14 \$1.2 million. (TAC ¶ 14.) RINO's Chinese Value Added Tax ("VAT")  
15 return showed 2009 revenue of only \$9 million. (TAC ¶ 15.) Thus,  
16 the reports approved by Frazer listed revenues and profits between  
17 ten and twenty times higher than the figures reported in RINO's tax  
18 documents. Plaintiff argues that the conflict between the tax  
19 documents and RINO's financial statements indicates that RINO was  
20 keeping two sets of books and providing inflated numbers to  
21 investors. (Reply at 10.) Indeed, the TAC alleges that the  
22 Securities and Exchange Commission ultimately suspended trading in  
23 RINO securities in part because of the existence of two separate  
24 and materially different sets of corporate books and accounts.  
25 (TAC ¶ 35.)

26 The TAC further alleges that Frazer was aware of the  
27 discrepancy between RINO's tax returns and reported revenue, and  
28 therefore knew that RINO was cooking the books to mislead

1 investors. (TAC ¶ 13.) On March 29, 2010, Frazer sent a letter to  
2 RINO's management highlighting several "significant deficiencies"  
3 in RINO's internal financial controls. (TAC, Ex. C.) This letter  
4 noted that RINO was not current on its issuance or receipt of VAT  
5 invoices, and explicitly stated that "[w]hen the Company files the  
6 tax return with the Chinese Government Tax Bureau, the reportable  
7 book amount does not agree with the tax return for both the VAT tax  
8 return and income tax return." (Id.) Nevertheless, Frazer did not  
9 consider this conflict to be a "material weakness" in RINO's  
10 financial report. (Id.) Frazer's letter nevertheless suggested  
11 that RINO change the way it accounted for VAT on both the sales and  
12 purchase sides of RINO's business. (Id.)

13         The court must compare the both the innocent and malicious  
14 inferences supported by the alleged facts. NMSIC, 641 F.3d at  
15 1095. Plaintiff argues that Frazer's decision to approve RINO's  
16 financial statements, despite Frazer's knowledge of the discrepancy  
17 with the tax return numbers, supports the inference that Frazer  
18 knew its opinion that RINO complied with GAAP to be false. (Replay  
19 at 10-11.)

20         Frazer contends that its recognition of the deficiency in  
21 RINO's figures demonstrates Frazer's diligence, and that Frazer's  
22 decision to label the conflicting figures a "significant  
23 deficiency" rather than a "material weakness" was the result of  
24 considered professional judgment. (Opposition at 13-14.) Frazer  
25 argues that the difference between the Chinese tax figures and  
26 RINO's reported income and profit numbers was the result of  
27 differences between Chinese tax law and SEC accounting rules, which  
28 attach tax liability at different stages of a transaction. (Opp.

1 at 13.) For this reason, Frazer asserts, it suggested RINO change  
2 the way it handled VAT payments and receipts to address this  
3 serious, but not fundamental, issue with its VAT accounting.  
4 Frazer further argues that the difference between the tax returns  
5 and SEC filings does not demonstrate the existence of two sets of  
6 books because the returns referenced in and attached to the  
7 complaint only apply to a single RINO subsidiary. Its SEC filing,  
8 however, included figures from all RINO entities.

9 The facts alleged support the inference that Frazer approved  
10 fraudulent figures. That inference, however, is at odds with  
11 Frazer's explicit identification of the accounting weakness and  
12 suggestion of a course of action to remedy it. The potential  
13 alternative explanations for the competing revenue figures,  
14 particularly the limited scope of the Chinese tax returns, lend  
15 further weight to the innocent inference here. A fraudster of even  
16 minimal competence would be unlikely to ignore such a blatant  
17 impropriety as maintaining two sets of books, yet at the same time  
18 identify and criticize that improper practice. Frazer's knowledge  
19 of the differing reported financial figures, therefore, is not  
20 alone sufficient to support a strong inference of scienter.

## 21 2. Reliance Upon Nonexistent Contracts

22 RINO's internal documents indicate that RINO earned \$11.1  
23 million from its contracts in 2009 and \$15.75 million in 2008.  
24 (TAC ¶ 98(e).) These figures are consistent with those indicated  
25 in RINO's tax forms and, like those figures, represent only a  
26 fraction of the revenues stated in the financial report approved by  
27 Frazer. Plaintiff alleges that RINO improperly used a "percentage  
28 of completion" method to record revenue based on contracts that

1 were not finalized.<sup>2</sup> (TAC ¶ 10). The TAC further alleges that  
2 Frazer not only knew that RINO improperly used percentage of  
3 completion accounting, but affirmatively directed RINO to utilize  
4 that method in ways that violated GAAP. (TAC ¶ 11.) For example,  
5 the TAC alleges that Frazer told RINO to include in its 2009  
6 revenue contracts that were not signed or did not take effect until  
7 2010, after the applicable reporting period. (Id.)

8 The TAC further alleges that many of the RINO customers listed  
9 in RINO's report either did not exist or had not purchased goods or  
10 services from RINO.<sup>3</sup> (TAC ¶¶ 123, 167-179.) Plaintiffs contend  
11 that Frazer failed to adequately check the status of the supposed  
12 customers and contracts, even though RINO's CEO told Frazer that  
13 some customer contracts were merely incomplete "framework  
14 agreements," and that "there were (sic) some uncertainty about  
15 execution of the framework agreements." (TAC ¶¶ 47, 170.) The TAC  
16 acknowledges, however, that Frazer did send some sort of  
17 confirmation form to RINO's purported customers. (TAC ¶ 176.)

18 Plaintiff argues that auditing standards required Frazer to  
19 conduct a certain type of investigation of RINO's customers. (Opp.  
20 at 17; TAC ¶ 165). Specifically, the TAC cites to Public Company  
21 Accounting Oversight Board ("PCAOB") auditing standard sections AU  
22  
23

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24 <sup>2</sup> Under the percentage of completion method, revenue on long-  
25 term projects is recognized based on the percentage of work  
26 completed to date. In re Daou Systems, Inc., 411 F.3d 1006, 1012-  
13 (9th Cir. 2005).

27 <sup>3</sup> While Plaintiff argues that up to 40% of the listed  
28 customers did not purchase anything from RINO or did not exist,  
that figure appears to include listed customers that Plaintiff's  
investigator was not able to contact.



1 311, 319, and 326.<sup>4</sup> Nowhere, however, does the TAC or Plaintiff's  
2 opposition specify the subsections of those lengthy auditing  
3 standards with which Frazer failed to comply. Indeed, Plaintiff's  
4 opposition makes no mention of AU sections 311, 319, or 326.  
5 Instead, Plaintiff's opposition conclusorily asserts, without  
6 citation, that "PCAOB auditing standards for percentage of  
7 completion accounting required that Frazer obtain confirmation of  
8 more information than simply the amount the customer believed it  
9 currently owed RINO." (Opp. at 17.) Though Plaintiff makes some  
10 limited references to the American Institute of Certified Public  
11 Accountant's Construction Contractors Audit & Accounting Guide,  
12 PCAOB standards make clear that such guides are recommendations,  
13 not auditing standards. AU § 150.05. Thus, while Plaintiff has  
14 alleged that Frazer could have performed a different or more  
15 thorough investigation of RINO's customers, Plaintiff has not  
16 alleged any specific facts related to percentage of completion  
17 accounting that alone indicate that Frazer violated accounting  
18 standards or support a strong inference of scienter.

19 3. Additional "red flags" and holistic review

20 If no individual allegation is sufficient to support a strong  
21 inference of scienter, the court must proceed to conduct a  
22 "holistic" review of those same allegations. NMSIC, 641 F.3d at  
23 1095. Allegations insufficient on their own may nevertheless, in  
24 combination, create a strong inference of recklessness or  
25 intentional conduct. Id. "[T]he more facts alleged that should

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27 <sup>4</sup> Neither party includes these auditing standards with their  
28 pleadings. AU sections 311, 319, and 326 have all been superseded,  
effective December 15, 2010, but remain available at  
[www.pcaobus.org](http://www.pcaobus.org).

1 cause a reasonable auditor to investigate further before making a  
2 representation, the more cogent and compelling a scienter inference  
3 becomes." Id. at 1098.

4 The irregularities described above, though insufficient to  
5 establish scienter on their own, more readily support an inference  
6 of wrongdoing when viewed as a whole, alongside other allegations.  
7 Frazer Frost knew that the revenue and profit numbers reported on  
8 RINO's tax returns did not match the figures reported to investors.  
9 The revenue numbers based on RINO's purported contracts matched the  
10 lower tax return numbers, not the higher figure approved by Frazer.  
11 Regardless whether Frazer's investigation of RINO customers  
12 conformed to accounting standards, Frazer knew that RINO was  
13 utilizing percentage of completion methods to reach its revenue  
14 figures, in part because Frazer advised RINO to do just that.  
15 Though Plaintiff has not identified any particular accounting  
16 standard related to percentage of completion, to the extent that  
17 Frazer advised RINO to count revenue from unsigned, unexecuted  
18 contracts, the parties appear to agree that inclusion of such  
19 revenue would be improper.

20 These are not the only allegations that might give rise to  
21 suspicion. The TAC alleges that RINO claimed a 100% income tax  
22 exemption in 2008. (TAC ¶ 78(f).) By the end of 2008, RINO had  
23 advanced \$22 million in cash to two of its major suppliers of raw  
24 materials. (TAC ¶ 95.) (TAC ¶ 96.) In 2009, RINO 93% of RINO's  
25 purchases, or \$79.4 million of raw materials, came from these two  
26 suppliers alone. (TAC ¶ 104.) One of the two suppliers was owned  
27 by RINO's CEO's nephew, and had no phone number or website. (TAC  
28 ¶¶ 106-107.) Neither did the larger of the two suppliers, which

1 did not exist before 2007, had no revenue in 2009, and was owned by  
2 RINO's CEO's mother. (TAC ¶¶ 108, 110.) By the end of 2009, RINO  
3 had advanced over \$34 million to these two suppliers.<sup>5</sup> (TAC ¶  
4 112.)

5 RINO was generous not only to its CEO's relatives, but also to  
6 the CEO himself. In 2009, as disclosed in the Frazer-approved  
7 report, RINO gave its CEO an interest-free, unsecured loan of \$3.5  
8 million for the purchase of a personal residence in California.  
9 (TAC ¶ 131.) As described above, Frazer has identified reasonable  
10 inferences that could be drawn from certain individual allegations.  
11 Frazer's argument that the allegations regarding millions of  
12 dollars in cash advances do not establish scienter because  
13 Plaintiffs have failed to allege that such advances are "contrary  
14 to standard Chinese business practices or were otherwise  
15 commercially unreasonable" is far less persuasive.<sup>6</sup> (Opposition at  
16 11.)

17 The question before the court at this stage is, "When the  
18 allegations are accepted as true and taken collectively, would a  
19 reasonable person deem the inference of scienter at least as strong  
20 as any opposing inference?" Tellabs, 551 U.S. at 326. Viewed as a  
21 whole, the totality of the allegations supports fraud. Allegations  
22 of tens millions of dollars in cash advances to a small number of  
23 shadowy suppliers, a claimed 100% income tax exemption, millions of  
24

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25 <sup>5</sup> Though it is unclear from the complaint whether Frazer saw  
26 or should have seen certain Chinese filings, RINO's Chinese filings  
27 listed \$0 in advances at the end of both 2008 and 2009. (TAC ¶¶  
96, 112.)

28 <sup>6</sup> Frazer does not directly address the personal loan to RINO's  
CEO or the improperly claimed tax credit.

1 dollars in unsecured loans to corporate officers, wildly divergent  
2 revenue and profit figures, and the inclusion of admittedly  
3 uncertain "framework agreements" as revenue provide far more  
4 support to the inference that Frazer knowingly or recklessly  
5 approved RINO's fraudulent financial statements than to the  
6 competing inferences that RINO's figures were the result of China's  
7 tax rules, innocent misapplication of accounting methods, or  
8 standard business practices. Plaintiff's has sufficiently alleged  
9 scienter.<sup>7</sup>

10 **IV. Conclusion**

11 For the reasons stated above, Frazer Frost's Motion to Dismiss  
12 is DENIED.

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14 IT IS SO ORDERED.

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17 Dated: August 1, 2013

  
DEAN D. PREGERSON  
United States District Judge

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26 <sup>7</sup> Frazer also argues that Plaintiff has failed to demonstrate  
27 subjective falsity "for the same reasons that Plaintiff has failed  
28 to demonstrate scienter." (Mot. at 19.) Because Plaintiffs have  
adequately pled scienter, their subjective falsity allegations also  
suffice.

## General Information

|                           |   |
|---------------------------|---|
| <b>Case Name</b>          | Susan Hufnagle v. Rino International Corporation et al              |
| <b>Docket Number</b>      | 2:10-cv-08695   |
| <b>Court</b>              | United States District Court for the Central District of California |
| <b>Nature of Suit</b>     | Statutes: Securities/Commodities/Exchanges                          |
| <b>Related Opinion(s)</b> | 2013 BL 11987; 2013 BL 205132                                       |