UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF ILLINOIS

EASTERN DIVISION

LAWRENCE E. JAFFE PENSION PLAN, ON BEHALF OF ITSELF AND ALL OTHERS SIMILARLY SITUATED,	Lead Case No. 02-C-5893 (Consolidated)
Plaintiff,	CLASS ACTION
- against -	Judge Ronald A. Guzman Magistrate Judge Nan R. Nolan
HOUSEHOLD INTERNATIONAL, INC., ET AL.,	
Defendants.	

REPLY MEMORANDUM OF LAW IN FURTHER SUPPORT OF DEFENDANTS' MOTION TO COMPEL PLAINTIFFS TO SUPPLEMENT THEIR INITIAL DISCLOSURES PURSUANT TO FED. R. CIV. P. 26(a)(1)(A)(iii)

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Plaintiffs' opposition brief ("Pl. Br.") states that their damages theory asserts that during the Class Period Defendants failed to correct misleading statements that introduced artificial inflation into Household's stock price ***before*** the Class Period (July 30, 1999 to October 11, 2002) began.[1] According to Plaintiffs, Defendants' silence during the Class Period "keeps the stock at an inflated price," after that inflation arose (somehow) prior to the Class Period. *See* Feb. 7, 2008 Status Conf. Tr. at 19; *see also* Plaintiffs' Feb 6, 2008 Status Report at 3 ("Household's stock may have been inflated since the beginning of the old Class Period (October 23, 1997), (or even before that time).").

Because Plaintiffs thus intend to rely on the failure to cure misleading statements or omissions made before the start of the Class Period, and they acknowledge, as they must, that Rule 26(a)(1) requires disclosure of "information and documents that the disclosing party may use to support its claims or defenses" (Pl. Br. at 4), it is absurd for them to argue that they do not have to disclose what the alleged statements or omissions were, when they were made and how Plaintiffs contend they caused Household's stock price to become artificially inflated. In the Seventh Circuit, a claim of securities fraud must assert that the alleged fraud first artificially inflated a company's stock price and that sometime later investors suffered damages when the truth of that fraud was revealed. In other words, "plaintiffs must show ***both*** that defendants' alleged misrepresentations artificially inflated the price of the stock and that the value of the stock declined once the market learned of the deception." *Ray* v. *Citigroup Global Markets, Inc.*, 482 F.3d 991, 995 (7th Cir. 2007) (emphasis added).

Yet Plaintiffs continue to withhold disclosures as to when and how they contend Household's stock price became inflated as a result of fraud. Their counsel's excuse that they "don't know when there is zero inflation in Household's stock before the class period" (remarks of Mr. Burkholz, Feb. 7, 2008 Status Conf., Tr. at 18) cannot be reconciled with their assertion that the inflation was introduced at some point by reason of alleged fraud. The claim that Plaintiffs are entitled to damages

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[1] *See*, *e.g.*, Pl. Br. at 8 (asserting that "Plaintiffs' position is that defendants' omissions on July 30,1999 caused Household's stock to be inflated on that day," and asserting, *inter alia*, an intent to "use defendants' failure on July 30, 1999 to correct the earlier July 22, 1999 statement" in support of the claimed fraud).

based on Defendants' alleged failure to cure fraudulent disclosures made before July 30, 1999 is ***their*** claim. The allegation that something had caused the price of Household stock to become inflated before that date is ***their*** allegation, and it is impossible to see how they can substantiate their position on this key subject without explaining when "defendants' alleged misrepresentations artificially inflated the price of the stock." *Ray,* 482 F.3d at 995.

Plaintiffs' implication that the starting point of the alleged "artificial inflation" cannot be known is also untenable. It goes without saying that there was zero artificial inflation in the stock price the day before — and every day before — the fraud that Plaintiffs allege began. Defendants are entitled to know what fraud or frauds Plaintiffs contend introduced the artificial inflation that is the very basis of their theory of damages. The validity of that claim cannot be tested until Plaintiffs disclose when (*i.e.*, the specific date or dates) the alleged "artificial inflation" upon which they base their claim for damages arose. As things now stand, under Seventh Circuit law, Plaintiffs have provided only ***half*** of the required showing.

ARGUMENT

A. Plaintiffs Must Fully Disclose Their Theory of Damages

Federal Rule of Civil Procedure 26(a)(1)(A)(iii) requires Plaintiffs to provide Defendants with a calculation of their damages as well as information known to them "bearing on the nature and extent of injuries suffered." Because Plaintiffs' damages model is built on an alleged amount of artificial inflation they contend was present in Household's stock for each day of the Class Period before certain alleged corrective disclosures were made,[2] Plaintiffs' refusal to provide information regarding source of the alleged artificial inflation renders their stated damages model incomplete.

Plaintiffs cannot credibly claim that the pre-Class Period inflation is irrelevant to their theory of damages. The pre-Class Period inflation is exactly the same inflation that Plaintiffs claim De-

[2] Lead Plaintiffs' Supplemental Statement Regarding Damages Pursuant to the Court's October 17, 2007 Order, at 1 (Oct. 24, 2007).

fendants' Class Period omissions kept in the stock price. It is also the same inflation that Plaintiffs claim was removed from the stock price when the "truth" was allegedly revealed in 2002. Plaintiffs' argument that it is enough to ***assume*** that some unspecified fraud introduced the artificial inflation into the stock price at some unspecified time before the Class Period started is specious. Although Professor Fischel confirmed that Plaintiffs instructed him to make this assumption *(See* Rebuttal Report of Daniel R. Fischel, at ¶36 ("My analysis is premised on my assumption that artificial inflation in Household's stock price began on July 30, 1999")), and that he did no independent verification of that point,[3] an unsubstantiated assumption is proof of nothing. Even though Plaintiffs have decided not to adduce an expert opinion on their theory, Plaintiffs still have the burden of proving that the assumption underlying their claim of damages is valid, and to do that they must introduce facts that show how and when the alleged inflation incepted.

Plaintiffs identify absolutely no case law to support their position that identifying when the fraud started (and inflation was first introduced into the stock price) is irrelevant to their securities fraud claim. The following are the assertions about the law that Plaintiffs make and the support that they provide for those positions:

Plaintiffs' Premise	Support Provided
"The analysis with respect to any inflation in Household's stock on any day prior to the first day of the Class Period (July 30, 1999) is not required in either proving a §10b claim or any damages related to such a claim." Pl. Br. at 2.	Plaintiffs cite no case law to support this proposition.
"With respect to 'economic loss' or damages, plaintiffs will need to show inflation in Household's stock price ***during*** the Class Period, not ***prior*** to the Class Period." Pl. Br. at 2 (emphasis original).	Plaintiffs cite no case law to support this proposition.

[3] It has become clear that it was this assumption — made at Plaintiffs' instruction — that "prevented" Professor Fischel from estimating pre-class inflation. Plaintiffs admit that they "took a precautionary approach and ***instructed their expert to measure inflation back to July 30, 1999 as opposed to August 16, 1999.***" Pl. Br. at 2-3 (emphasis added). There is no reason that Plaintiffs could not have "instructed" Professor Fischel to "measure inflation back" to some time before July 30, 1999.

"Defendants' argument that any pre-Class Period artificial inflation was immutably 'baked' in once the Class Period began, thus, runs counter to both law and economic theory." Pl. Br. at 9.	Plaintiffs cite no case law to support this proposition.
"There is no requirement that defendants' false statements during the Class Period increase inflation each time." Pl. Br. at 9.	Plaintiffs cite no case law to support this proposition, and *Ray* v. *Citigroup Global Markets, Inc.*, 482 F.3d 991, 995 (7th Cir. 2007) is contrary.

Putting aside the lack of any legal support for Plaintiffs' substantive position, Plaintiffs' supposed disagreement with Defendants' understanding of the law does not excuse their refusal to provide the required Rule 26 disclosures ***in discovery***. *See Payne* v. *Philadelphia*, 2004. U.S. Dist. LEXIS 8425 (E.D. Pa. May 5, 2004) (ordering a party to produce, in accordance with Rule 26(a)(1)(A)(iii), underlying factual information bearing on the party's damages claim); *Union Carbide Corp.* v. *State Board of Tax Commissioners*, 161 F.R.D. 359, 366 (S.D. Ind. 1993) ("discovery should not be denied because it relates to a claim or defense that is being challenged as insufficient.") quoting, 8 Charles A. Wright and Arthur R. Miller, *Federal Practice and Procedure* § 2008, p. 44 (1970); *Kemper/Prime Industrial Partners* v. *Montgomery Watson Americas, Inc.*, 97 C 4278, 2004 U.S. Dist. LEXIS 5543 (N.D. Ill. Mar. 31, 2004) (Guzman, J.) (imposing sanctions under Fed. R. Civ. P. 37 where Plaintiff had "failed to produce any evidence in discovery that would allow a trier of fact to determine the existence or extent of its damages" as required by Fed. R. Civ. P. 26(a)(1)(A)(iii)).

To date, Plaintiffs have grudgingly disclosed limited, incomplete aspects of their theory of damages after repeated Orders from this Court. Plaintiffs have stated that they "intend to propose the use of a FIFO (first-in, first-out) method of matching purchases and sales,"[4] nevertheless asserting that the inception of pre-Class Period inflation is irrelevant to their proposed "FIFO" damages calculation.[5] According to Plaintiffs, "pre-Class Period purchases . . . are only relevant to the extent that they are used

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4 Lead Plaintiffs' Further Supplement to Their Prior Statements Regarding Damages, at 1 (Feb. 1, 2008).

5 Feb. 7, 2008 Status Conf. Tr., at 17 (Mr. Burkholz: "under FIFO pre-class period inflation is not relevant to damage calculations").

under the FIFO method to 'match' up with the Class Period sales, ***which matching up is not used in any calculation of gains or losses under lead plaintiffs' damages theory***."[6] Plaintiffs' position is not consistent with existing authority.

Indeed, another court has derided as "unrealistic" the identical theory advanced by Plaintiffs here that "shares sold during the Class Period that are paired (for accounting purposes) with shares purchased before the Class Period are not considered when computing total loss over the Class Period." *See In re Organogenesis Securities Litigation*, 241 F.R.D. 397 (D. Mass. 2007). The *Organogenesis* Court explained why it would be impossible to evaluate Plaintiffs' damages without reference to the amount of artificial inflation, if any, that existed before the Class Period:

> "Imagine an investor who 1) buys a share of stock ***before a fraud*** for $ 10, 2) buys a share after a fraud drives up the price to $ 20, 3) shortly thereafter, sells a share at the same elevated price, 4) holds his remaining share until after the fraud becomes known, and 5) sells his remaining share for $ 10. ***Using Plaintiffs' FIFO method, the sale of the stock during the class period would constitute a gain over the first purchase (pairing transactions 3 and 1) which is not considered for the purpose of computing gain or loss during the Class Period. A Class Period computation that does not include this gain would be unrealistic because this sale was at an elevated price due to the fraud.*** It is even more troubling that the investor would then be able to report a loss of $ 10 on the purchase of the share at $ 20 made during the class period (by pairing transactions 5 and 2). And so, even though the investor would have bought and sold a share at $ 20 and bought and sold a share at $ 10, Plaintiffs' proposed methodology would lead to the conclusion that the investor lost $ 10 as a result of the fraud."

Id. (emphasis added). *See also Johnson* v. *Dana Corp.*, 236 F.R.D. 349, 353 (N.D. Ohio 2006) (***rejecting*** a plaintiff's argument that "because courts do not award damages for losses with respect to pre-existing shares, courts should likewise not subtract profits from the sale of those shares when calculating damages").

Courts in this District have explicitly recognized the significance of pre-Class Period inflation and transactions to determine the ***amount*** of a plaintiff's damages:

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[6] Lead Plaintiffs' Further Supplement to Their Prior Statements Regarding Damages, at 2 (Feb. 1, 2008) (emphasis added).

> "Consider an Investor A with accumulated holdings of 10,000 shares of XYZ Corporation that were acquired ***when everything was on the up and up in terms of corporate disclosures***, and that represent the investor's long-term commitment to the company's prospects. Assume further that unknown to Investor A but during what later turns out to be a plaintiffs' class period--a time when the nondisclosure of adverse information caused the stock price to be too high in terms of real value--Investor A both buys and sells an aggregate of 5,000 shares of XYZ stock in various transactions before the stock price later falls out of bed, and that such class-period transactions leave Investor A neither out of pocket nor in pocket when the expenditures for and the proceeds of those transactions are aggregated. ***Is there any real question that Investor A, who has thus retained the same long-term stake in XYZ that preceded the class period, has sustained neither gain nor loss from the transactions during the class period***?"

In re Comdisco Securities Litigation, 2004 U.S. Dist. LEXIS 7230 (N.D. Ill. Apr. 26, 2004) (emphasis added).

Plaintiffs improperly seek to evade their Rule 26 obligation to provide the complete picture of their claimed damages and alleged inflation. Pl. Br. at 2 ("The analysis with respect to any inflation in Household's stock on any day prior to the first day of the Class Period (July 30, 1999) is not required in either proving a §10b claim or any damages related to such a claim."). ***Plaintiffs cite no authority to support this position and, as noted above, existing authority is to the contrary***. *See*, *e.g.*, *Ray* v. *Citigroup Global Markets, Inc.*, 482 F.3d 991, 995 (7th Cir. 2007) ("plaintiffs must show both that defendants' alleged misrepresentations artificially inflated the price of the stock and that the value of the stock declined once the market learned of the deception."); *see also, e.g., Comdisco Securities Litigation*, *Organogenesis Securities Litigation,* and *Johnson* v. *Dana Corp*., *supra*.

The damages implications of Plaintiffs' failure to explain when and how artificial inflation arose before the Class Period are also evident from the hypothetical Defendants raised in their opening brief, the relevance and correctness of which Plaintiffs do not dispute in their opposition brief. Assume that a company misrepresented Fact A in 1985, Fact B in 1990, and Fact C in 1995. Suppose that a plaintiff then brought suit under the securities laws, alleging that the company's stock price was "artificially inflated" by $10 per share as a result of the company's misrepresentations of Fact A, Fact B, and Fact C, and that the company had committed a "continuing violation" of the securities laws by omitting to disclose the truth of Fact A, Fact B, and Fact C in its SEC filings during the period beginning July 30,

1999. The plaintiff might claim, as the Plaintiffs claim here, that the full amount of artificial inflation was fully present in the company's stock price on July 30, 1999, the first day of the Class Period. Suppose that this hypothetical plaintiff claimed that the truth regarding Fact A, Fact B, and Fact C was revealed in 2002, removing the $10 per share of alleged artificial inflation from the company's stock price. If, however, the truth of Fact A were actually revealed to the market on January 1, 1998, then the plaintiff could not claim per-share damages for the portion of the $10 of artificial inflation attributable to Fact A. But without knowing when the plaintiff alleged that inflation resulting from the misrepresentation of Fact A entered the stock price, and the extent of the "artificial inflation" attributable to Fact A, it would be impossible to determine what part of the total $10 inflation the plaintiff would be entitled to recover. In such a case, as here, the Plaintiffs' incomplete explanation of their theory of damages would not permit the Court to determine classwide damages.

Defendants are also entitled to prove at trial that information regarding the alleged frauds was known to the market before July 30, 1999. *See Roots Partnership* v. *Lands' End, Inc.*, 965 F.2d 1411, 1419 (7th Cir. 1992) (dismissing plaintiff's fraud-on-the-market claim that they were misled into purchasing the defendant's securities on July 25, 1989 by earnings projection made on April 4, 1989 because the company had disclosed its actual first quarter earnings on May 18, 1989, prior to plaintiffs' purchase, and under plaintiff's own efficient market theory this information should have been incorporated into the price prior to plaintiff's purchase on July 25). Under *Roots Partnership*, the class may not recover for any portion of the alleged $7.97 per share of artificial inflation that relates to information that was fully known to the market before July 30, 1999. As Plaintiffs have asserted the existence of unspecified frauds that allegedly inflated the stock price before the Class Period began, Defendants are entitled to know the details of that allegation in order to determine whether related information was in fact known to the market before the Class Period in connection with those claims. The parties and the Court will also need to know when (*i.e.*, the date or dates) the "artificial inflation" upon which Plaintiffs'

theory of damages is based first arose in Household's stock price in order to determine classwide damages.[7]

B. Plaintiffs' Purported Lack of Knowledge of Their Own Theory of Damages is No Basis to Avoid the Required Disclosures

Plaintiffs do not only disclaim (incorrectly) any legal obligation to explain the source of the pre-Class Period artificial inflation they claim. To support their obstructive position on this issue, they also disclaim (implausibly) ***any knowledge with respect to their own claim that the stock price became inflated prior to the Class Period***. *See* Feb. 7, 2008 Status Conf. Tr., at 18 (Mr. Burkholz: "we don't know when there is zero inflation in Household's stock before the Class Period"); *see also* note 3, *supra*. As Plaintiffs are the party to have asserted the existence of this inflation on the first day of the Class Period, they cannot credibly claim to have no idea whatsoever about how or when it came to be there on that day. This unresolved issue is not merely a "slight twist" (Pl. Br. at 8) to Plaintiffs' theory for which ignorance can be offered in place of an explanation.

As noted above, it is axiomatic that there was zero inflation in the stock price the day before — and every day before — the alleged fraud began. Plaintiffs base their claims on Defendants' alleged failure to reveal (during the Class Period designated by the Court) the truth of (unidentified) pre-Class Period misstatements that actually inflated the stock price.[8] Plaintiffs assert that Defendants' si-

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[7] Beyond the damages issue, information regarding when and how the artificial inflation arose is relevant to Defendants' statute of repose argument. Suppose that the statement that introduced the $7.97 of inflation was made on January 1, 1982, which is a distinct possibility given Plaintiffs current Rule 26 (a)(1)(A)(iii) disclosure. As Judge Guzman held, the statute of repose bars claims based on violations of §10(b) that occurred before July 30, 1999. *Lawrence E. Jaffe Pension Plan* v. *Household International, Inc.*, 2006 WL 560589 (N.D. Ill. Feb. 28, 2006). Therefore, Plaintiffs could not recover for the inflation introduced by a false statement in 1982 because it pre-dates July 30, 1999 by more than the repose period. Plaintiffs claim that every single day that Defendants failed to correct that statement over the next twenty years would be a new separate violation of the securities law. Such a position would eviscerate the very purpose of the statute of repose. As Judge Guzman stated when holding that the three year statute of repose applied in this case, "tolling principles — equitable estoppel and equitable tolling — do not apply to the statute of repose for securities fraud claims because its purpose is to set an outer limit that is unaffected by what plaintiff knows." *Id.*

[8] Pl. Br. at 2 ("Plaintiffs' damage theory (Fischel Rebuttal Report, ¶¶36-38) is that if the Household Defendants had disclosed the truth about the Company's actual business practices on Day One of the Class Period (July 30, 1999), Household's stock would have declined to its true value").

lence on these issues during the Class Period "keeps the stock at an inflated price." *See* Feb. 7, 2008 Status Conf. Tr. at 19. Plaintiffs' contention that the source of this artificial inflation is unknowable is simply illogical — not to mention inconsistent with a meritorious claim of securities fraud.

If Plaintiffs contend that Defendants' failure to correct pre-Class Period false statements maintained artificial inflation in the stock price, their theory logically must include when the pre-Class Period false statements were made that introduced the alleged artificial inflation. Plaintiffs cannot claim damages based on Defendants' allege failure to correct pre-Class Period false statements without disclosing the basis of that claim. *Gallagher* v. *Abbott Laboratories*, 269 F.3d 806, 810 (7th Cir. 2001) (dismissing plaintiffs' complaint, which advanced the theory that defendants violated their duty to correct a prior 10-K report, because "a statement may be 'corrected' only if it was incorrect when made"); *Wafra Leasing Corporation v. Prime Capital Corporation*, No. 01 C 4314, 2004 U.S. Dist. LEXIS 17468, at *49 (N.D. Ill. Aug. 31, 2004) (holding where plaintiff advanced a theory of liability based on defendant's failure to correct its 1997 audit, plaintiff "must show at trial that [defendant] discovered that the 1997 audit was incorrect within the alleged time frame" and "must also show that the 1997 audit contained untrue information").

Plaintiffs contend that "daily inflation is the sum total of inflation in Household's stock price on that day as reflected in the fraud-related declines from November 14, 2001 to October 11, 2002." Pl. Br. at 2. Plaintiffs' explanation of their theory of damages provides only half of the required disclosure. Plaintiffs fail to acknowledge what the Seventh Circuit made clear in *Ray*: a securities fraud plaintiff must prove that "defendants' alleged misrepresentations artificially ***inflated the price of the stock***." *Ray* v. *Citigroup Global Markets, Inc.*, 482 F.3d 991, 995 (7th Cir. 2007) (emphasis added). (emphasis added). *Ray* makes clear that Plaintiffs theory of damages cannot be explained except by reference to the fraud that they allege inflated the price of Household's stock.

Plaintiffs cannot simply substitute the beginning of the Class Period for the actual inflation of the stock price as required by *Ray*. Plaintiffs' theory of damages rests on the alleged amount of artificial inflation present in Household's stock price on a daily basis, and thus also rests on the premise that at some point Household committed a fraud that artificially inflated the price of the stock. In order

to defend properly against this so-far unsubstantiated claim, Defendants need to know, and are entitled by Rule 26(a)(1) to know, when and how the artificial inflation that is fundamental to Plaintiffs' theory of damages arose.

CONCLUSION

For the foregoing reasons, Defendants respectfully request that Defendants' motion to compel be granted and that Plaintiffs be compelled to disclose when (*i.e.*, the specific date or dates) and how the "artificial inflation" upon which Plaintiffs' claim for damages is based was first introduced into Household's stock price.

Dated: February 25, 2008

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CERTIFICATE OF SERVICE

The undersigned attorney certifies that on February 25, 2008, he caused to be served copies of **Reply Memorandum of Law In Further Support of Defendants' Motion To Compel Plaintiffs To Supplement Their Initial Disclosures Pursuant to Fed. R. Civ. P. 26(a)(1)(A)(iii)** to the parties listed below via the manner stated.

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