UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF ILLINOIS

EASTERN DIVISION

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

MEMORANDUM OF LAW IN SUPPORT OF DEFENDANTS' MOTION PURSUANT TO LOCAL RULE 16.1 TO REQUIRE PLAINTIFFS TO IDENTIFY THE ALLEGEDLY FALSE AND MISLEADING STATEMENTS TO BE PROVED AT TRIAL

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This memorandum is respectfully submitted on behalf of Defendants Household International, Inc., William F. Aldinger, David A. Schoenholz, and Gary Gilmer (collectively, "Household" or "Defendants")[1] in support of Defendants' Motion Pursuant to Local Rule 16.1 to require Plaintiffs to Identify the Allegedly False and Misleading Statements to be Proved at Trial.

INTRODUCTION

This six-year-old securities fraud case is scheduled to go to trial in a little over four months and the Final Pretrial Order must be delivered to the Court in a matter of weeks.

In exchanging pretrial materials required to meet this schedule, however, Plaintiffs refused to identify the statements they intend to prove at trial were false and misleading. Instead, Plaintiffs have taken the indefensible (for a securities fraud case) position that "plaintiffs do not believe that in this case it is necessary or appropriate to include each false statement or omission in the jury instructions or verdict form."[2] This unfounded position is squarely at odds with the Securities Exchange Act of 1934, which requires a securities fraud plaintiff to prove that each defendant made a false and misleading statement, and that each allegedly false statement made by that defendant was material, made with scienter and actually caused Plaintiffs to suffer a loss. Failure to prove any element for any statement precludes liability for securities fraud based upon that statement.

Plaintiffs' submissions in this case demonstrate their intention to make this trial about anything but securities fraud. They have repackaged disputed but long-settled consumer claims under the heading "predatory lending" and improperly seek a finding of securities fraud detached from any actual statements of fact to the investing public. Plaintiffs' unstated premise is that the inflammatory proof they intend to offer of what they characterize as "predatory lending" will suffice and

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1 Defendants Joseph A. Vozar and Household Finance Corporation ("HFC") join in this motion and expressly reserve the right to amend, supplement or re-assert objections to Plaintiffs' proposed pretrial order materials to the extent that at any future time Plaintiffs propose to use these materials in a trial of claims asserted against Mr. Vozar and HFC.

2 Declaration of Thomas J. Kavaler ("Kavaler Decl.") dated December 11, 2008, Ex. 1.

substitute for identification and proof of actual false statements, because the company has never accused itself of being a "predatory lender." This is not the law.

At trial, the jury must be told what statements and claims of falsity are at issue, and therefore, in their submissions for the pretrial order, Plaintiffs must identify those statements now. Each individual Defendant is also entitled to an identification of the statement(s) he is alleged to have falsely made, in order to prepare an adequate defense. Plaintiffs' adamant refusal to identify a single statement that they intend to prove was a violation of the securities laws is nothing less than an improper effort to evade the scrutiny that the federal law of securities fraud mandates. Ultimately, it is also an effort to confuse and mislead the jury, which the Court can easily avoid by simply requiring Plaintiffs to address the required elements of securities fraud that they would prefer to elide.

BACKGROUND

On July 30, 2008, the Court set the jury trial for March 30, 2009 and ordered that the final pretrial order be submitted on January 30, 2009. In order to comply with the Court's order, Local Rule 16.1, the Standing Order Establishing Pretrial Procedure for the Northern District of Illinois Eastern Division and the Final Pretrial Order Form, the parties agreed to a schedule by which they would exchange the materials required to be submitted to the Court on January 30, 2009. On October 31, 2008, Plaintiffs provided a facially defective proposed verdict form, jury instructions and statement of contested issues of fact and law. (Kavaler Decl., Exs. 2 - 4). Among various other failings, these documents were deficient because none identified even a single statement that Plaintiffs intend to prove at trial to be false and misleading. For example, Plaintiffs' proposed verdict form does not contemplate asking the jury whether any false or misleading statement was ever made by any Defendant. Rather, it contemplates asking only whether each defendant "violated the Securities Exchange Act of 1934." (Kavaler Decl. Ex. 2 at 1).

On November 7, 2008, Defendants raised this deficiency by letter asking Plaintiffs to amend their documents to include identification of "the particular alleged false statements or omissions that Plaintiffs intend to prove at trial . . .." (Kavaler Decl. Ex. 5). Plaintiffs refused to do so.

Without explaining or justifying their position, Plaintiffs merely stated in a letter dated November 10 that they "do not believe that in this case it is necessary or appropriate to include each false statement or omission in the jury instructions or verdict form." (Kavaler Decl. Ex. 1).

Local Rule 16.1(a) states that "[p]ursuant to Fed. R. Civ. P. 16, the Court has adopted a standing order on pretrial procedures. . .." Section 6 of the Standing Order, which concerns the period between notice and the date for submission of the pretrial order, states that "[i]f, after reasonable effort, any party cannot obtain the cooperation of other counsel, it shall be his or her duty to advise the court of this fact by appropriate means." Accordingly, Defendants have made this motion.

ARGUMENT

The cornerstone of every federal securities fraud claim is the existence of false and misleading statement made to investors. Plaintiffs' claim will fail unless they successfully prove to the jury that each Defendant made false statements, either through a particular affirmative misstatement or through a statement that misleadingly omits necessary particulars. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5; *Basic Inc.* v. *Levinson*, 485 U.S. 224, 231-232 (1988); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 474-75 (1977); *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336, 342 (2005) (identifying a misleading statement as the first of the six "basic elements" of a securities fraud claim).

The existence of a misrepresentation is so fundamental to proving a federal securities fraud claim that even at the earliest stage of litigation, the filing of the complaint, the PSLRA requires that plaintiffs "specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading. . . ." 15 U.S.C. § 78u-4(b)(1), (2). "[F]raudulent misrepresentations must be separately identified. An allegation of fraudulent misrepresentation is not sufficient if it merely states that misrepresentations were made." *Spicer* v. *Chicago Board Options Exchange, Inc.*, No. 88 C 2139, 1990 U.S. Dist. LEXIS 14469, at *25-*31, *31n.9 (N.D. Ill. Oct. 24, 1990) (Will, J.) (dismissing all allegations of fraud by misrepresentation in view of Plaintiffs' failure to identify "a single false or misleading statement" and analyzing each of the three alleged omissions separately).

Correspondingly, "[a]n allegation of an omission alleges what it is that allegedly was not said". *Id.* at *31; *see Spatz* v. *Borenstein*, 513 F. Supp. 571, 578-80 (N.D. Ill. 1981) (Moran, J.) (on a motion for summary judgment, analyzing sentence by sentence each alleged "affirmative misrepresentation[ ]" and each alleged omission (e.g. that defendant "failed to disclose that 25 of 562 units in the Laurel Glen apartment complex were 'below grade' and thus uninhabitable")).

Allegations contained in a complaint and other pleadings are ***not*** a substitute for identifying a party's contentions for trial in a pretrial order, because the pretrial order controls the subject matter of trial and the complaint does not. Likewise, the verdict form and jury instructions identify the alleged false statements for the jury to consider, and the complaint does not. This is what the Federal Rules require. The Court of Appeals looks to these documents in reviewing any jury verdict. It does not consider the pleadings. As the Court of Appeals has stated: "[**T**]***he pretrial order is treated as superseding the pleadings***...." *Gorlikowski* v. *Tolbert, II*, 52 F.3d 1439, 1444 (7th Cir. 1995) (emphasis supplied); *see also Nagy* v. *Riblet Products Corp.*, 79 F.3d 572, 575 (7th Cir. 1996). A plaintiff's burdens are not relaxed as the litigation proceeds to trial. If anything, those burdens increase.

The Federal Rules contemplate a pre-trial effort by plaintiffs to focus more narrowly claim alleged in the pretrial order and related materials.[3] This focusing effort makes trial more efficient and thereby improves the process for all participants. *Gorlikowski*, 52 F.3d at 1444; *see also* Fed. R. Civ. P. 16(c), Advisory Committee's Notes to 1983 Amendment (noting how pretrial conference has aim of "promoting efficiency and conserving judicial resources by identifying the real issues prior to trial"). "An essential task in fulfilling that purpose is to clearly set forth the various issues the parties intend to litigate." *Wilson* v. *Kelkhoff*, 86 F.3d 1438, 1442 n.6 (7th Cir. 1996).

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[3] Apart from the lack of focus of Plaintiffs' voluminous pleadings and the lack of actual substantive content in the pretrial documents that are the subject of this motion, plaintiffs' other pretrial submissions have been similarly unhelpful. Plaintiffs current trial exhibit includes over 3200 exhibits, including includes virtually every SEC filing made by the company over the three-year Class Period, most of which themselves contain thousands of statements.

But even if Plaintiffs make no effort whatsoever to focus for trial the wide-ranging claims asserted or mentioned in hundreds of pages of prior pleadings (many of which have since been dismissed), it is still necessary and required for them to identify each false statement they want the jury to consider. Fed. R. Civ. P 49(a) governing special verdict questions "requires a district court to submit [as verdict questions] all material issues raised by the pleadings and evidence." *United States Fire Insurance Co.* v. *Pressed Steel Tank Co.*, 852 F.2d 313, 318 (7th Cir. 1988); *see also Bularz* v. *Prudential Insurance Co. of America*, 93 F.3d 372, 377 (7th Cir. 1996). The verdict form and jury instructions cannot simply reference the complaint--something Plaintiffs' proposed forms do not do in any event.

Both the Federal Rules and Seventh Circuit law have imposed serious consequences on parties who fail to "make a full and fair disclosure of their views as to what the real issues of the trial will be." *See, e.g., Erff* v. *Markton Industries, Inc.*, 781 F.2d 613, 617 (7th Cir. 1986) (precluding theories of recovery not advanced in the pretrial order). Parties will be precluded from taking positions at trial that were not disclosed and authorized in the Final Pretrial Order. *See Gorlikowski* v. *Tolbert, II*, 52 F.3d 1439, 1444 (7th Cir. 1995) ("[A] claim or theory not raised in the pretrial order should not be considered by the fact-finder."); *see also id.* at 1445 (party precluded from changing jury instructions in final pretrial order to reflect theory of recovery asserted for the first time at closing argument); *accord Nagy*, 79 F.3d at 575 (describing Seventh Circuit's "stringent rule of forfeiture" in final pretrial order context). Rule 16 of the Federal Rules of Civil Procedure requires that a party cannot lightly be relieved of the contents of its final pretrial order, otherwise "[p]arties could always avoid the disclosure and oversight that Rule 16 authorizes simply by asserting new claims or defenses at trial. Rule 16 does not permit such sleight of hand." *Gorlikowski* v. *Tolbert, II*, 52 F.3d 1439, 1444 (7th Cir. 1995); *see also Smith* v. *Rowe*, 761 F.2d 360, 365-66 (7th Cir. 1985) (enunciating four-factor test); 3 James W. Moore, *Moore's Federal Practice* § 16.78[4][a], at 16-215 (3d ed. 2008) (observing that "the spirit of [the Seventh Circuit's test] may be less hospitable to motions to modify final pretrial orders than the spirit of the test endorsed by the Second Circuit").

Misrepresentations and omissions are more than simply the origin of every securities fraud litigation. Their relevance pervades a 10(b) action, touching upon every element of the fraud claim. *See Ray* v. *Citigroup Global Markets, Inc.*, No. 03 C 3157, 2005 U.S. Dist. LEXIS 24419, at *5 (N.D. Ill. Oct. 18, 2005) (Kennelly, J.) ("To prevail on such a claim, a plaintiff must demonstrate that the defendant made a material misrepresentation or omission with scienter in connection with the purchase or sale of securities, that the plaintiff reasonably relied on the misrepresentation, and that the plaintiff suffered economic loss which was caused by the misrepresentation.") Failure to prove any one of these elements with respect to any claimed misrepresentation or omission will preclude a plaintiff's recovery for that alleged misrepresentation. *See, e.g., Searls* v. *Glasser*, 64 F.3d 1061, 1066 (7th Cir. 1995) (granting defendants' motion for summary judgment after analyzing each alleged misrepresentation); *Central Laborers' Pension Fund* v. *Sirva, Inc.*, No. 04 C 7644, 2006 U.S. Dist. LEXIS 73375 (N.D. Ill. Sept. 22, 2006) (Guzman, J.) (analyzing materiality and scienter with respect to each specified misrepresentation and omission); *Ray*, 2005 U.S. Dist. LEXIS 24419, at *5 (granting defendants' motion for summary judgment on loss causation where the stock price did not significantly decline following the revelation of the alleged misrepresentations). Plaintiffs' failure to identify even one allegedly false statement therefore amounts to a fatal defect at trial.

Of particular importance in this case is the effect, *vel non*, of any alleged misrepresentation on the Company's stock price and the element of loss causation. If the jury is not told which particular statements made during the Class Period were allegedly false then it will be unable to determine when, if ever, that statement introduced inflation into the stock price, and when, if ever, the revelation that the particular statement was false caused the stock price to decline, removing the inflation. The Supreme Court has emphasized that this analysis cannot be done on the vague gestalt approach Plaintiffs favor here. *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336, 342-43 (2005) (holding that proving loss causation requires establishing a "causal connection between the material misrepresentation and the loss" and that it is not enough for the misrepresentation to simply "touch upon" a loss.) The Court of Appeals recently echoed this sentiment in *Tricontinental Industries, Ltd.* v. *PricewaterhouseCoopers, LLP*, 475 F.3d 824 (7th Cir. 2007).

In *Tricontinental*, plaintiffs argued that the claimed misrepresentations in the defendant's 1997 financial statements were factually revealed to the public in later disclosures relating to 1998 and 1999 financial statements because "the 1997 fraud was part of an on-going scheme to overrepresent revenue". *Id*. at 842. Plaintiffs argued that "nowhere in *Dura* does the Supreme Court require that the precise fraud that resulted in the underlying transaction be the subject of a later corrective disclosure in order to satisfy loss causation." *Id.* at 843 (citations omitted). The Court of Appeals, however, rejected this argument *id.* ("[w]e cannot accept this rendition of *Dura*'s requirements"), concluding that the plaintiffs had not plausibly connected the claimed "corrective disclosure" of the truth with the alleged misrepresentation to establish the requisite causation of the claimed loss. *Id.* ("Tricontinental had to allege that PwC's 1997 audit contained a material misrepresentation which caused Tricontinental to suffer a loss when that material misrepresentation 'became generally known.'"). If a disclosure reveals the falsity of only some of the alleged misrepresentations, then Plaintiffs can recover only for the losses resulting from those statements. *See Id*. at 844 (noting that "Tricontinental has alleged only that it experienced loss as a result of the exposure of misrepresentations contained in Anicom's 1998 and 1999 financial statements" and finding this insufficient to reveal the alleged fraud with respect to 1997 financial statements).

As the Court of Appeals has stated, Plaintiffs must prove "both that the 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). As a result, it will be impossible for the jury to determine not only which, if any, statement inflated the stock price or if that inflation was ever removed through a corrective disclosure, but it will also be impossible for the jury to determine which members of the Class, if any, can recover for which alleged false statement or how much. *Denny* v. *Barber*, 576 F.2d 465, 468-69 (2d Cir. 1978) ("if [plaintiff] himself cannot share in any recovery because no fraudulent statements were issued before his purchase, he would not be a proper representative of persons who bought securities after fraudulent statements were issued if indeed this occurred) (citations omitted); *see Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737-38 (1975).

Federal Rules 16 and 49 and this case law serve to limit the burdens imposed on the jury by a long, inefficient trial. *See* 3 *Moore's Federal Practice* §§ 16.71[1], 16.77[1]. They also ensure fairness to the parties by allowing them to prepare for trial knowing precisely what is in controversy. *See Erff* v. *Markttton Industries, Inc.*, 781 F.2d 613, 617 (7th Cir. 1986); *see also Nagy* v. *Riblet Products Corp.*, 79 F.3d 572, 575 (7th Cir. 1996) ("The document controlling the course of trial is the pretrial order under Fed. R. Civ. P. 16. Each side plans for trial on the assumption that it needs to meet only the contentions its adversary identifies in that order."); 3 Moore's § 16.77[4][a][i]. It stands to reason that if Plaintiffs are allowed to keep all possible options open by not specifying the statements they intend to prove at trial, the PTO cannot serve its intended purpose and Defendants and the Court will be forced to prepare for every possible contention.

Offering the jury no guidance about what statements they have in mind, Plaintiffs' proposed jury instructions merely acknowledge that "plaintiffs bear the burden of proving by a preponderance of the evidence that the defendant [sic] made an untrue statement of fact or omitted a material fact when making a statement." (*See, e.g.*, Kavaler Decl. Ex. 3 at 68). This failure to identify even a single statement makes the jury's evaluation impossible. Apparently Plaintiffs' plan is to have the jury render a general and unfocused verdict without regard for the individual elements of a federal securities fraud claim. (*See* Kavaler Decl. Ex. 2 at 1). Refusing to assist the jury with an identification of the alleged false statements is a key part of Plaintiffs' plan. It is not consistent with the law in this Circuit, however.

The Court of Appeals has ruled that Fed. R. Civ. P 49(a), governing special verdict questions, "requires a district court to submit all material issues raised by the pleadings and evidence." *United States Fire Insurance Co.* v. *Pressed Steel Tank Co.*, 852 F.2d 313, 318 (7th Cir. 1988). "A question may be based on the terms or requirements of a statute, but if it is, it ought to include all of the elements of the statute." 9B Charles A. Wright & Arthur R. Miller, *Federal Practice & Procedure, Civil 3d* § 2508, at 144-45 (2008) (citing *Merchant's Fast Motor Lines, Inc.* v. *Lane*, 259 F.2d 336, 338 (5th Cir. 1958) (Wisdom, J.), and *FSLIC* v. *Third National Bank*, 173 F.2d 192

(6th Cir. 1949)).[4] The existence of a misrepresentation is not only an element of securities fraud, it is the necessary predicate upon which any claim rests and which grounds all the other elements. *See Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336, 342 (2005) (identifying a misleading statement as the first of the six "basic elements" of a securities fraud claim)

The deficiency of Plaintiffs' proposed verdict form is readily evident from a comparison to those used in other recent class action securities fraud trials. Indeed, Defendants are aware of no verdict form in any post-PSLRA § 10(b) class action that has gone to jury verdict that has ***not*** presented special verdict questions as to each element of the claim, and for each alleged misstatement or omission. (*See* Kavaler Decl. Exs. 6 - 8 (attaching verdict forms from *In re Apollo Group Inc. Securities Litigation* (D. Ariz. 2008); *In re JDS Uniphase Corp. Securities Litigation* (N.D. Cal. 2007); *In re Clarent Corp.* (N.D. Cal. 2005)).

In fact, after noticing the omission of a question covering one of the 10(b) elements, the *Clarent* court issued an Order to add this question. The Order stated, in relevant part: "[T]he Court realized that the proposed verdict form does not include a special interrogatory regarding loss causation even though a loss causation instruction is given. This omission is problematic because the jury is instructed that an essential element of the 10(b) claim is that the plaintiffs suffered damages as a result of a defendant's misrepresentation. The Court therefore directs the parties to include in the

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[4] Local Rule 16.1(a) also states that "[p]ursuant to Fed. R. Civ. P. 16, the Court has adopted a standing order on pretrial procedures." The standing order on pretrial procedure adopted by this Court instructs that if there is no Court of Appeals pattern instruction, the Court will default to a pattern instruction from another circuit. While the Court of Appeals does not have any pattern instructions on the element of misrepresentation in a securities fraud case, two of the three circuits that have promulgated pattern instructions for securities cases explicitly require that the jury be instructed on what specific misrepresentations or omissions are alleged. *Pattern Jury Instructions: Eleventh Circuit, Civil Cases* § 4.2 (2005); *Pattern Jury Instructions: Fifth Circuit, Civil Cases* § 7.1 (2006). While the only other circuit to promulgate pattern instructions for securities cases, the Ninth Circuit, does not have an explicit instruction requiring such identification, in the three most recent securities class action trials that have gone to a jury verdict within the Ninth Circuit special verdict questions identifying each alleged misstatement or omission were given to the jury. *See, e.g.*, *In re Apollo Group Inc. Securities Litigation* (D. Ariz. 2008); *In re JDS Uniphase Corp. Securities Litigation* (N.D. Cal. 2007); *In re Clarent Corp.* (N.D. Cal. 2005) (Kavaler Decl. Exs. 6 - 8.)

phase I verdict form a special interrogatory which asks the jury to find this element with respect to ***each alleged misstatement***." (Kavaler Decl. Ex. 9) (emphasis supplied). These other verdict forms not only identify the statements that the jury must consider, but an examination of these forms shows why the identification of the alleged misleading statements is important to the jury's evaluation of the other elements of Plaintiffs' claims.

Because the jury must rely on these documents to correctly perform its duty, the integrity of these documents speaks directly to the validity of any verdict. As the Court of Appeals has observed: "A special verdict question may be so defective in its formulation that its submission constitutes reversible error. A judgment entered upon an answer to a question which inaccurately frames the issue to be resolved by the jury must be reversed." *Umpleby* v. *Potter & Brumfield, Inc.*, 69 F.3d 209, 214 (7th Cir. 1995) (citing 9A Wright & Miller, *Federal Practice and Procedure, Civil 2d* § 2508, and *Cann* v. *Ford Motor Co.*, 658 F.2d 54, 58 (2d Cir. 1981) (and citations therein), *cert. denied*, 456 U.S. 960 (1982)).

The parties cannot effectively meet the relevant trial deadlines without this indispensable information. Plaintiffs' ongoing refusal to provide it threatens to derail the entire pretrial process. Defendants cannot properly identify which witnesses they will call or which exhibits they will need. The Individual Defendants cannot know which of their own statements, if any, will at trial be alleged by Plaintiffs to be false and as a result, whether their are in fact any claims against them to be tried. *See* 15 U.S.C. §78t(a); *Harrison* v. *Dean Witter Reynolds, Inc.*, 79 F.3d 609, 614 (7th Cir. 1996) (Wood, J.) (under § 20(a), a "control person" is one who "possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated"). For example, if Plaintiffs do not intend to prove that any specific statement made by Gary Gilmer was false and misleading then Mr. Gilmer should properly be dropped as a defendant.

Of course, the purpose behind this deliberate obfuscation is apparent. Plaintiffs wish to have the jury punish the defendants for Plaintiffs' inflammatory characterizations (of disclosed practices) as "predatory lending" irrespective of any legal requirements applicable to claims for secu-

rities fraud. As one court noted, "use of special verdict forms is designed precisely to avoid a verdict based upon the jury's sympathies or view of who should prevail regardless of the controlling law." *Munafo* v. *Metropolitan Transportation Authority*, 277 F. Supp. 2d 163, 173 (E.D.N.Y. 2003). Plaintiffs must therefore be held to the actual requirements of federal securities fraud law, and the example of recent cases like *In re Apollo Group Inc. Securities Litigation* (D. Ariz. 2008), *In re JDS Uniphase Corp. Securities Litigation* (N.D. Cal. 2007) and *In re Clarent Corp.* (N.D. Cal. 2005). (Kavaler Decl. Exs. 6 - 8).

CONCLUSION

For the foregoing reasons, pursuant to Local Rule 16.1 Defendants respectfully request that Plaintiffs be ordered forthwith to identify in their proposed verdict form each statement that they intend to prove is false and misleading and that all other pretrial materials including the proposed jury instructions and statement of contested issues of fact and law be conformed to address under the law of securities fraud each allegedly false and misleading statement to be proved to the jury.

Dated: December 11, 2008
New York, New York

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