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, vs. HOUSEHOLD INTERNATIONAL, INC., et al., Defendants.	Lead Case No. 02-C-5893 (Consolidated) CLASS ACTION Judge Ronald A. Guzman Magistrate Judge Nan R. Nolan

MEMORANDUM OF LAW IN SUPPORT OF PLAINTIFFS' MOTION TO EXCLUDE CERTAIN TESTIMONY OF DEFENDANTS' EXPERT ROMAN L. WEIL PURSUANT TO FEDERAL RULE OF EVIDENCE 702

PLAINTIFFS' MOTION *IN LIMINE* NO. 9

[REDACTED VERSION]

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I. INTRODUCTION

Plaintiffs respectfully submit this memorandum of law in support of their motion *in limine* to exclude certain testimony of defendants' designated expert witness Roman L. Weil ("Weil"). In his expert report (the "Weil Report") and during his deposition, Weil offers numerous opinions that are inadmissible under Fed. R. Evid. 702.

Weil offers several improper opinions concerning the policies and practices Household International, Inc. ("Household" or the "Company") used to derive the publicly-reported performance statistics for its loans. These statistics were supposed to show whether Household's customers were delinquent in the loans extended to them by Household. Household had a variety of practices and policies used to report delinquent customers as "current" customers, thus making the quality of their loan portfolio appear better than it was in reality. Household often referred to these policies as "re-aging" or "restructuring" an account.

Weil opines that Household's re-aging practices were "common" in Household's industry because such techniques "enhance cash flow." Weil Report at 18-27 (attached hereto as Ex. A). These opinions fail under Rule 702 because they are the products of speculation, inadequate factual support and flawed methodologies.

Weil also opines that Household's re-aging practices are not misleading so long as Household took into account the delinquent loans that it reports as "current" in its loan loss reserves. For example, when asked "Would re-aging loans to reduce the number of two plus [two months late] delinquencies reported, conceal Household's credit quality?," Weil responds, "***Not if the reserves are adequate***." March 12, 2008 Deposition Transcript of Roman L. Weil ("Weil Depo.") at 192:8-11 (excerpts attached hereto as Ex. B). Weil concludes that Household's reserves were in fact adequate based on Exhibits 3-4 of his report, which he summarizes in footnote 64 of his report. Weil's method is so flawed that even he "would like to have a better answer." *Id*. at 249:15.

Finally, Weil improperly tries to bolster defendants' credibility by offering opinions as to defendants' ***state of mind***. For example, he opines Household's $600 million accounting restatements in 2002 were "not examples of fraud" and that defendants did not intentionally break any accounting rules. Weil Report at 54.

For the reasons set forth below, Weil's opinions are inadmissible under Rule 702.

II. ARGUMENT

District courts determine whether evidence may be admitted as a preliminary matter. *See* Fed. R. Evid. 104(a); *United States v. Martinez de Ortiz*, 907 F.2d 629 (7th Cir. 1990) (en banc). Fed. R. Evid. 702 sets the standards governing the admissibility of expert testimony:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.

The text of Rule 702 and applicable case law establish three major prerequisites to admissibility. First, the proffered testimony must substantially assist the trier of fact. *See* Rule 702 advisory committee's notes to 1972 Proposed Rules ("When opinions are excluded, it is because they are unhelpful and therefore superfluous and a waste of time."). Second, the witness must qualify as an expert as to each opinion. *See Ueland v. United States*, 291 F.3d 993, 997 (7th Cir. 2002) (overturning ruling that lack of credentials and education in field affected only weight accorded expert testimony). Finally, the opinion must be reliable. *See Daubert v. Merrell Dow Pharms.*, 509 U.S. 579 (1993) (setting forth reliability factors a district court may consider); *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999) (clarifying *Daubert*'s analytical framework applies to all types of expert testimony); Fed. R. Evid. 702 advisory committee's notes to 2000 Amendments (citing *Daubert* and *Kumho* with approval).

When the correct framework is applied, admitting or excluding the expert evidence at issue is within the district court's discretion. *Kunz v. DeFelice*, 538 F.3d 667, 675 (7th Cir. 2008) ("[the Seventh Circuit] reviews *de novo* whether the district court understood the legal requirements of Rule 702, and then reviews decisions to admit or exclude expert testimony for abuse of discretion"). However, it is the proponent's burden to demonstrate that each element is satisfied. *See* Fed. R. Evid. 104(a); *Bourjaily v. United States*, 483 U.S. 171, 175 (1987) ("The preponderance standard ensures that before admitting evidence, the court will have found it more likely than not that the technical issues and policy concerns addressed by the Federal Rules of Evidence have been afforded due consideration.").

A. Weil's Opinions that Household's Re-age Practices Were Designed to "Benefit Cash Flow and Net Income" and Were "Common" in Its Industry Are Unhelpful and Unreliable

In questions 6, 7 and 8 of his report, Weil offers several opinions concerning the reasons why Household re-aged its loans during the Class Period. In question 6, Weil hypothesizes that re-aging is used "to enhance cash flow and accounting profits," Weil Report at 19; in question 7, Weil hypothesizes that re-aging was used by "others" for reasons other than manipulating a company's reported credit quality statistics, *id.* at 19-21; in question 8, Weil purports to "demonstrate that the industry recognizes as common the re-aging practices described [in questions 6 and 7], ***and that they benefit cash flow and net income***." *Id.* at 21-24 (emphasis added). Weil's opinions are inadmissible under Rule 702 because they are unhelpful and unreliable.

As to all opinions, they are unhelpful because Weil simply cuts and pastes block quotes from documents that defense counsel can readily introduce at trial. *See Dhillion v. Crown Controls Corp.*, 269 F.3d 865, 871 (7th Cir. 2001) ("'An expert . . . must testify to something more than what is "obvious to the layperson" in order to be of any particular assistance to the jury.'") (citation omitted).

In addition, the method Weil uses to "demonstrate" that Household's re-aging practices were not credit quality concealment techniques but were, instead, designed to "benefit cash flow and net income," is deeply flawed. If any of Weil's theories is well suited to quantification, this is it. An accountant, Weil does not point to a single number in support of his theory. Rather, he quotes from analyst reports that simply parrot Household management's statements that re-age practices have an economic benefit. Weil Report at 21-23; *see also* Weil Depo. at 164:18-166:18. None of these "reports" quantify the benefit to Household. These analysts and Weil fail for good reason: ***not even Household could demonstrate any net economic benefit associated with re-aging***.

> Q: Did you ever ask anyone if there was any analysis done establishing one way or another if the manner in which Household restructured loans, in fact, did increase cash flow?
>
> A: Yes.
>
> Q: And what was the response?
>
> A: We don't know of any.

Weil Depo. at 176:20-177:1.

In fact, the analyses Household did conduct (***after*** the market started to question its loan quality) demonstrated that "'[l]ate stage restructures appear to do little to improve the long-term performance of the portfolio.'" Corrected Rule 26 Statement of Harris L. Devor ("Devor Report"), ¶196 (quoting Household document) (excerpts attached as Ex. C hereto). Here, Weil's refusal to consider what Household ***actually did*** in its re-aging practices is similar to the expert's refusal in *Barber v. United Airlines, Inc.*, 17 F. App'x 433 (7th Cir. 2001), to consider percipient accounts of weather conditions during a weather-related incident.

As in *Barber*, defense expert Weil ignores a party's own statements that do not support his opinion. *Id.* at 437 ("Dr. Hynes also did not adequately explain why he ignored certain facts and data, while accepting others. Nor did Dr. Hynes present any other data which supported his opinion

– he merely accepted some of the testimony and weather data that suited his theory and ignored other portions of it that did not."). The bottom line is that neither Weil nor Household ever could quantify a net economic benefit to its re-age policies and practices.

As to what the "industry" considered "common," Weil ignores a detailed analysis cited in Devor's report that shows Household did not use re-aging as "others" in the industry did. For example, below was a finding made by Wells Fargo's due diligence team after weeks of intensive investigation into Household's re-aging accounting practices:

[redacted]

See Devor Report, ¶329.

To the extent Weil offers no opinions other than "Household thought" that the manner in which it restructured its loans increased cash flow, Weil Depo. at 173:1-24, or that "I think Household believed at all times that its policies of dealings with customers [focused on re-aging] were designed to enhance cash flows," *id*. at 174:2-8, these lack any basis in fact and are not helpful to the jury since Weil simply speculates as to defendants' state of mind. It is a waste of trial time and a violation of Rule 702 to allow Weil simply to bolster defendants' credibility.

Weil's opinions in his questions 6, 7 and 8 are little more than a collage of articles coupled with speculation that Weil never ties to the facts of this case. They are inadmissible.

B. Weil's Opinions that Household's Loss Reserves Were Adequate Are Unreliable

In question 6 of his report, Weil posits: "In accounting, ***so long as the allowance for uncollectible receivables (often referred to as the reserve) is adequate***, there is no accounting issue

with respect to the operational policy of planned forbearance." Weil Report at 19 (emphasis added and in original). (Weil uses the term "planned forbearance" synonymously with "re-age." *Id.* at 18-19.) In question 13 and elsewhere, Weil opines: "My analysis below, which compares [Household] to eight other comparable companies, finds ***no evidence that [Household] ever had inadequate allowances for uncollectibles***." *Id*. at 28 (footnote omitted; emphasis added). He further concludes: "[Household's] method for computing its allowances for loans losses, which are comparable to techniques common used in this industry, follow GAAP and ***provide results that match actual outcomes***." *Id*. at 3.

According to Weil, the arithmetic Household applied to calculate its loan loss reserves was "first independently deriving [A] statistical and [B] judgmental reserves, then adding them to get [C] total reserves." *Id*. at 34. According to Weil, so long as increased non-payment and charge-off risk associated with "re-aged" loans – *i.e.*, those that are reported as "current" but in fact are "late" – are captured in the total reserves, it is immaterial whether Household's re-age policies are accurately disclosed. *See, e.g.*, Weil Depo. at 162:23-163:5 ("Q: Well, wouldn't exceptions to the company's chargeoff policies that allowed the company to keep bad loans on the books longer be something that the reasonable investor would want to know about? . . . A: ***Not if the reserves were adequate***.") (emphasis added); *id.* at 192:8-11 ("Q: Would re-aging loans to reduce the number of two plus delinquencies [two months' late] reported, conceal Household's credit quality? A: ***Not if the reserves are adequate***.") (emphasis added).

The only "proof" Weil has to support his theory that Household's re-aged delinquent loans and charge-off statistics were adequately covered in Household's "total reserves" is a series of charts that purport to demonstrate that Household's reserves and charge-off statistics were similar to those of its "peers" during the Class Period. *See* Weil Report at 28 n.64; Weil Report, Exs. 3-4. Weil

confirmed the fact that he conducted no other analysis to determine the adequacy of Household's reserves:

> Q: What analysis did you perform to determine whether Household's reserves were adequate, necessary and not excessive during the class period.
>
> * * *
>
> A: . . . ***The only analysis that I was able to do was to compare Household's allowances as ratios to other financial statement items in contrast to other comparable companies***, benchmark companies, similarly situated as described, illustrated in the exhibits starting with number three, I think.

Weil Depo. at 124:9-23 (emphasis added). Weil's opinions that Household did not mislead investors as to the credit quality of its loans because its loan loss reserves were adequate cannot withstand Rule 702 scrutiny.

First, Weil failed to include the most crucial building blocks to his loss reserve comparative analyses. In order for Weil's method to work, as a practical matter Household must have re-aged its loan portfolio by the same amount as its peers. However, there is no question that Household re-aged its loan portfolio more than industry peers. Weil admits this fact in his report:

[redacted]

Weil Report at 23 (emphasis added). And Weil acknowledged this fact during his deposition. Weil Depo. at 195:18-22 ("Q: Do you have any understanding as to whether Household re-aged more loans than its peers? A: Yes. Q: And what is your understanding? A: ***They did***.") (emphasis added).

Thus, Weil assumes what he seeks to prove, much like "demonstrating" that an athlete never took steroids because she finished a race at the same time as the rest of her competitors. Weil's methodology to determine whether reserves were adequate, to the extent he employed one, would

never be accepted by other accountants or survive peer review. *See Daubert*, 509 U.S. at 593-94. Weil candidly admits this fact:

> Q: Who decided to analyze the adequacy of the reserves in this fashion?
>
> A: I did.
>
> Q: And would this analysis be sufficient for an auditor to rely upon in determining the adequacy of Household's reserves?
>
> A: ***No***.

Weil Depo. at 125:13-19 (emphasis added).

Second, Weil has inadequate bases for using ***other companies***' reserves and charge offs as the "control group" data he compares with Household. In order for the eight "comparable" companies to form a valid "control group," for Weil's purposes, he must know the key variables causing those eight companies to reach their reported results. He must also know that the nature and age of the loan receivables of the eight companies as well as the borrower characteristics of those eight companies are equivalent (not just similar) to Household's before concluding that Household's reserve should mirror the reserves of the control group. Simply stated, a reserve must be responsive to the needs of the ***company's*** specific receivable make-up, not its competitors. A competitors' level of reserves is irrelevant without this knowledge.

However, Weil provides no analysis that the eight companies calculate their reserves in the same way as Household; he does not have access to any of their workpapers; has not discussed his findings with their auditors or management; and does not know what assumptions they used in calculating their "judgmental" reserves.

Third, even if Weil had all of this "peer" data, his analysis would still fail because he did not analyze and does not test whether ***Household*** captured the myriad Class Period changes to its re-age practices and policies in its own statistical reserves (the "[A]" component to the method Weil claims

Household used to derive [C] "total reserves," discussed above) or judgmental reserves (the [B] component).

Weil did not test whether Household's method for deriving its statistical reserves, called a "roll rate" (*i.e.*, the rate at which a customer who misses one payment, will miss two payments, etc., or "rolls" into the later delinquency buckets), captured all of the re-age changes the Company made during the Class Period. The following deposition examination focuses on a document created ***by Household*** summarizing numerous re-age policies and changes and Weil's failure to examine them:

[redacted]

A: I see that, thank you.

[redacted]

Did you assess the impact of that change?

A: No.

Q: And is it fair to say that you did not assess the impact of any of these changes here?

A: Yes.

Q: Okay. So is it also fair to say that you have no idea as to the impact of these changes on the statistical reserve requirement that Household used?

A: Yes.

Weil Depo. at 144:18-145:15. (A copy of Weil Depo. Ex. 8 marked by plaintiffs is provided for the Court's convenience as Ex. D hereto.)

Weil admits that "[w]hen you change your policy of re-aging and its is significant to [sic] relative to the other accounts, the roll rate method by itself will not get you to the right answer, which is why you have judgmental reserves." Weil Depo. at 152:20-25. Weil states that he believes

Household accounted for these changes in its judgmental reserves, *id*. at 133:12-23, but incredibly can cite not one fact in the "5 million" page record supporting his position that Household ***actually*** included the impact of re-age changes in its judgmental reserves:

> Q: What I'm trying to understand is whether you've seen any facts in the record or anything from a Household employee that demonstrates that the impact of policy changes for re-ages was specifically considered in the judgmental reserve?
>
> A: I have no recollection of asking that question in conversation and I have no recollection of documents on that subject.

Id. at 134:5-12. Whether he reviewed any such documents or not, Weil's opinions regarding the adequacy of Household's reserves are completely untied to the facts of this case, and are inadmissible on that basis alone. *See United States v. Mamah*, 332 F.3d 475, 478 (7th Cir. 2003) ("It is critical under Rule 702 that there be a link between the facts or data the expert has worked with and the conclusion the expert's testimony is intended to support.").

Finally, as in *Kumho*, this Court should exclude Weil's opinions concerning Household's charge-off and loss reserves relative to other companies because "the expert seemed to deny the sufficiency of his own . . . methodology." *Kumho*, 526 U.S. at 155. As noted above, Weil admits his method is not appropriate for accountants to use, and further doubts its sufficiency as follows:

> Q: In reviewing Mr. Devor's report . . . did you develop any questions of your own that you haven't answered here?
>
> A: The only question that I developed that I would like to have a better answer than I have here is the one about the adequacy of the reserves. We talked about that earlier, I did my best to figure out ways you could test for the adequacy and I came up with the Exhibit [3 through 4] solution, but that's the only sort of question that I have in mind that can we find another way to do that that's more company specific."

Weil Depo. at 249:9-22.

Given the numerous flaws Weil uses to test the adequacy of Household's reserves, his opinions that they were adequate and thus rendered Household's manifold, undisclosed re-aging policies "immaterial" must be excluded.

C. Weil's "Opinions" Concerning Defendants' State of Mind Are Inadmissible

Household manipulated its cost accounting on various marketing agreements in order to make its financial position appear better than it was in fact. As a consequence, Household was forced to restate $600 million in earnings related to certain credit card agreements (the "Restatement").

Weil offers several impermissible "opinions" on management's state of mind in this context. First, in response to defense counsel's question, "Does the fact of an accounting restatement imply the fact of fraud," Weil responds, "No." Weil Report at 53. He acknowledges that "fraud is a broad legal concept" but he states from an accountant's perspective, "[t]he primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of financial statements ***is intentional or unintentional***" and concludes Household's restatements were "not examples of fraud." *Id.* at 53-54 (emphasis added).

Weil's "opinions" that management did not intentionally break any accounting rules or commit fraud are clearly inadmissible under Rule 702. They violate the first principle of Rule 702, which allows admission only "***[i]f*** scientific, technical, or other specialized knowledge ***will assist*** the trier of fact to understand the evidence or to determine a fact in issue." Fed. R. Evid. 702 (emphasis added). As the Fed. R. Evid. 702 advisory committee's note to the 2000 Amendments explains, the Rule "affirms the trial court's role as gatekeeper and provides some general standards that the trial court must use to assess the reliability ***and helpfulness*** of proffered expert testimony." (Emphasis added.) The jury will not need Weil's help in evaluating whether the individual defendants are

telling the truth as to whether their "underlying action" leading to the Restatement was "intentional or unintentional." Weil Report at 54.

Consistent with the text of Rule 702, courts have held that experts cannot be hired to bolster a witness's credibility. Under similar circumstances where intent was an issue in the case, *Safeway, Inc. v. Sugarloaf P'ship, LLC*, 423 F. Supp. 2d 531, 538 (D. Md. 2006), the court explained that "[t]o the extent his report speaks to the intent of the parties, it is unhelpful because [the expert] was not present [during the events at issue] and has no personal knowledge of the parties' intent." As in *Safeway*, if Weil "had such knowledge, his appropriate role would be as a fact witness, not an expert witness." *Id.*

Applicable audit and accounting standards preclude Weil from opining on whether defendants committed fraud. Professional audit standards state "auditors do not make legal determinations of whether fraud has occurred." AU §316.05: Consideration of Fraud in a Financial Statement Audit (excerpt attached as Ex. E hereto). Moreover, Weil cannot base his opinion on the two audit workpapers he cites in his report at page 54 because "an audit is not designed to determine intent." *Id.*

Even if those documents were sufficient from an auditing perspective to determine defendants' intent, Weil is barred as a matter of law from offering any opinions concerning defendants' state of mind since that determination is a legal question. *Good Shepherd Manor Found., Inc. v. City of Momence*, 323 F.3d 557, 564 (7th Cir. 2003) ("district court correctly ruled that expert testimony as to legal conclusions that will determine the outcome of the case is inadmissible") (citing *United States v. Sinclair*, 74 F.3d 753, 757 n.1 (7th Cir. 1996)).

Weil goes so far as to ***criticize*** plaintiffs' accounting expert for failing to opine on defendants' state of mind. Weil states that plaintiffs' expert "leaves it to the reader's imagination to conclude that, perhaps, [Household] ***committed the errors on purpose or to manipulate with***

foresight." Weil Report at 51 (emphasis added). Actually, Devor explains the accounting impact of the transactions underlying the Restatement, and leaves it to the jury to decide whether defendants had the requisite intent, which is exactly what Rule 702 and the applicable accounting standards require. All of Weil's "opinions" concerning any defendant's state of mind and the Company's "intent" are inadmissible, and Weil must be instructed not to make any statements concerning his "belief" regarding defendants' "intent" on this or any other issue before the jury.

III. CONCLUSION

For the foregoing reasons, plaintiffs respectfully request that this Court exclude Weil's opinions and testimony concerning the economic benefit of Household's re-aging practices; the adequacy of Household's reserves, or comparing its reserves to other companies' reserves; and defendants' states of mind at trial as described above.

DATED: January 30, 2009

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DECLARATION OF SERVICE BY ELECTRONIC MAIL AND BY U.S. MAIL

I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, a citizen of the United States and employed in the City and County of San Diego, State of California, over the age of 18 years, and not a party to or interested party in the within action; that declarant's business address is 655 West Broadway Suite 1900, San Diego, California 92101.

2. That on January 30, 2009, declarant served by electronic mail and by U.S. Mail to the parties the **MEMORANDUM OF LAW IN SUPPORT OF PLAINTIFFS' MOTION TO EXCLUDE CERTAIN TESTIMONY OF DEFENDANTS' EXPERT ROMAN L. WEIL PURSUANT TO FEDERAL RULE OF EVIDENCE 702 (REDACTED VERSION)**.

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I declare under penalty of perjury that the foregoing is true and correct. Executed this 30th day of January, 2009, at San Diego, California.

/s/ Teresa Holindrake
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EXHIBITS A-D FILED SEPARATELY UNDER SEAL