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-C5893 (Consolidated) CLASS ACTION Judge Ronald A. Guzman

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

(PLAINTIFFS' MOTION *IN LIMINE* NO. 9)

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This memorandum is respectfully submitted on behalf of Defendants Household International, Inc. ("Household"), William F. Aldinger, David A. Schoenholz and Gary Gilmer (the "Individual Defendants" and, collectively with Household, the "Household Defendants" or "Defendants"), in opposition to Plaintiffs' motion to exclude certain testimony of Defendants' expert Roman L. Weil pursuant to Federal Rule of Evidence 702.[1] For the reasons discussed below, Plaintiffs' motion should be denied.

PRELIMINARY STATEMENT

On August 15, 2007, Plaintiffs proffered the expert report of Mr. Harris L. Devor.[2] In his 150-page report, Mr. Devor listed various Household policies that benefited Household's customers (and therefore Household's shareholders) by incentivizing the payment of delinquent loans (*e.g.*, grace periods, forbearances, and loan restructures). Mr. Devor proceeded to characterize those policies as "credit quality concealment techniques" and claimed that the true intent behind them was to manipulate the company's financial statements.

Faced with Mr. Devor's "theory," Defendants engaged an expert to assess its validity. They chose Professor Roman L. Weil, a Ph.D., CMA, CPA, and the V. Duane Rath Professor of Accounting at the Graduate School of Business of the University of Chicago. Professor Weil received a BA in Economics and Mathematics from Yale University in 1962, an MS in Industrial Administration in 1965, and a Ph.D. in Economics in 1966, both from Carnegie Mellon University. He joined the faculty of the University of Chicago in 1965. Professor Weil has been a CPA in Illinois since 1973 and a CMA since 1974. He also has expertise in matters of corporate governance through corporate board member training as well as consulting work. (*See* Declaration of Thomas J. Kavaler in Opposition to Plaintiffs' Motions In Limine Nos. 1, 3-10 ("Kavaler Decl.") Ex. 15, Weil Rpt. at 1-2, Ex. A).

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[1] Defendants Joseph A. Vozar and Household Finance Corporation ("HFC") join in this opposition and expressly reserve the right to amend, supplement, or re-assert objections to any future motions by Plaintiffs to exclude documents and testimony from any proceeding or submission.

[2] A corrected version of Devor's Report, dated February 22, 2008, was served on March 8, 2008.

Professor Weil provided his expert report in response to Mr. Devor's report on December 10, 2007. He began by examining the common use of loan restructuring across the consumer finance industry, supporting his examination with numerous descriptions and explanations of the well-established practice in accounting and industry literature. Next, he considered the analysis conducted and conclusions reached by Mr. Devor, concluding that many of Mr. Devor's opinions were extrapolated from anecdotes that did not reflect Household's policies as a whole. Finally, Professor Weil searched for the telltale sign that would reveal whether Household was in fact using its restructure policies to delay charge-offs, namely insufficient loss reserves. He found none: not only did Household never take any charge to reserves or experience insufficient reserves, Household's reserves were always comparable to those in the industry. In sum, Household's loss reserves were not only adequate, but the adequacy itself strongly tends to disprove the "concealment" claimed by Devor. Professor Weil also considered and rejected Mr. Devor's conclusions that Household's accounting for certain complicated credit card marketing agreements was wrong, and that restatement was required.

Invoking Rule 702 and *Daubert* v. *Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993), Plaintiffs now object to Professor Weil's expert conclusions: (1) that Household's restructure practices were designed to "benefit cash flow and net income" and were common in the industry; (2) that Household's loss reserves were adequate; and (3) that Household's restatement resulted from a genuine professional disagreement among accountants concerning complex and novel questions of accounting. The purpose of the court's gate-keeping function under *Daubert*, however, is solely to exclude expert testimony that employs unreliable methods or reaches irrelevant results. Plaintiffs accuse Professor Weil of neither. Instead, the most Plaintiffs can muster is that they posit that Professor Weil should have performed *additional* hypothetical analyses to further bolster his opinion. Of course, *Daubert* does not require that Professor Weil perform Plaintiffs' "wish-list" of tests and procedures — Plaintiffs have their own expert for that.[3] Instead, *Daubert* requires only that an expert's testimony be reliable and relevant. As demonstrated below, Professor Weil's testimony easily meets that standard.

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[3] Incidentally, Mr. Devor himself did not perform the hypothetical analyses that Plaintiffs now argue Professor Weil omitted, thus critically hampering his conclusions.

Although Plaintiffs are free to take issue with Professor Weil's conclusions at trial, "[t]he focus [of this motion], of course, must be solely on principles and methodology, not on the conclusions that they generate." *Daubert*, 509 U.S. at 595. Because Plaintiffs' motion turns that principle on its head, it should be denied in full and Professor Weil's testimony should be admitted at trial — unless, of course, Mr. Devor's testimony is excluded (*See* Defendants' Daubert Motion to Exclude "Expert" Testimony of Harris L. Devor), in which event it would likely be unnecessary for Professor Weil to testify.

ARGUMENT

Under Federal Rule of Evidence 702, the court applies a two-pronged analysis to evaluate whether proffered expert opinion is admissible. *See Chapman* v. *Maytag Corp.*, 297 F.3d 682, 686 (7th Cir. 2002). First, the court makes a "preliminary assessment" to determine "whether the reasoning or methodology underlying the testimony is scientifically valid." *Id.* at 686-687 (citing *Daubert*, 509 U.S. at 592-93). Second, the court must determine "whether the evidence or testimony assists the trier of fact in understanding the evidence or in determining a fact in issue." *Id.* at 687 (citing *Porter* v. *Whitehall Labs, Inc.*, 9 F.3d 607, 616 (7th Cir. 1993). Professor Weil's proposed testimony meets both of these requirements and, therefore, it should be admitted at trial.

I. PROFESSOR WEIL'S OPINIONS THAT HOUSEHOLD'S RESTRUCTURE POLICIES WERE INNOCENTLY DESIGNED AND THAT SUCH POLICIES WERE COMMON IN THE INDUSTRY ARE BASED ON RELIABLE METHODOLOGY AND ARE HELPFUL TO THE JURY

Throughout his prolix 150-page report, Mr. Devor characterizes the practice of restructuring a borrower's loan account as a "credit quality concealment technique" concocted by Household in order to falsify its financial statements. What he fails to acknowledge is that restructuring is a practice used by all lending institutions and it is commonly believed to be both good for consumers (who avoid foreclosure) and profitable for lenders (who increase cash flow). In response, Professor Weil's testimony will provide the jury with the tools to evaluate the evidence. As he does in his report, Professor Weil will educate the jury as to the term "restructuring" (also called "reaging" or "planned forbearance") and its operational purpose implications as well as the difference between "restructuring" and other terms that Mr. Devor misapplies. In his report, Professor Weil explains that "reaging" can have two meanings — an adjustment to accounting for bad debts,

or a description of the operating policy known as planned forbearance or restructuring, which is designed to enhance cash flows. (Kavaler Decl. Ex. 15, Weil Rpt. at 18-19). He concluded that "In this case, 're-aging' means HI attempts to induce customers to pay more cash more timely than they otherwise would. It does not mean an attempt to manipulate income by understating expected non-collections." (*Id.* at 19).

In addition to his accounting and economics expertise, Professor Weil relied on academic material, including the leading textbook on financial accounting, which he authored. *See* Fed. R. Evid. 702 advisory committee's note (2000) (listing as a factor in determining the reliability of expert testimony: whether "experts are 'proposing to testify about matter growing naturally and directly out of research they have conducted independent of the litigation, or whether they have developed their opinions expressly for purposes of testifying'") (quoting *Daubert* v. *Merrell Dow Pharmaceuticals, Inc.*, 43 F.3d 1311, 1317 (9th Cir. 1995)).

Professor Weil also tested his understanding of the definition of restructuring against relevant accounting and lending industry literature, providing examples used in industry manuals, consumer credit websites, debt management companies, and even federal agency policy statements. The connection between Professor Weil's independent understanding of the practice and the use of the term in the lending industry illustrates that the industry interprets restructuring in the same manner as he does, validating his conclusion. This sort of methodology is entirely proper, as reasonable experts rely on the professional literature in their field. *See O'Conner* v. *Commonwealth Edison Co.*, 13 F.3d 1090, 1107 (7th Cir. 1994) ("The proper methodology, upon which any reasonable expert would rely, would include an examination of the [relevant] medical literature . . . ."). His use of extrinsic academic and industry literature demonstrates that, unlike Mr. Devor's newly minted term "credit quality concealment technique," Professor Weil's understanding of restructuring is not a moniker of convenience created for purposes of this case. (Kavaler Decl. Ex. 15, Weil Rpt. at 19-21). In theory and in practice, restructuring is designed to increase cash flow.

Plaintiffs argue without basis that Professor Weil's opinions are "unhelpful" to the jury. To the contrary, Professor Weil's ability to explain complex accounting and economics issues to non-experts — a talent that he has gained from his many years of experience not only as the leading authority in the field but also through his position of more than forty years as a professor at the University of Chicago — will be very helpful to the jury. *See* Fed. R. Evid. 702 advisory commit-

tee note (2000) (noting that the amendment to the rule does not change "the venerable practice of using expert testimony to educate the factfinder on general principles"). Professor Weil's testimony will be particularly helpful because Mr. Devor provides no context for his conclusions, falsely implying that the very act of restructuring is nefarious. Professor Weil evaluated Household's restructure policies, looking for indications that they were designed for some purpose other than to increase cash flow. He found none.[4]

Having supported his opinions with academic literature and industry materials, Professor Weil next examined the opinions of analysts — people whose job it is to have an intricate understanding of Household's business and to pick apart the Company's policies and practices. Analysts concluded that Household was restructuring in order to maximize cash flows and not to defer charge-offs and limit delinquencies as Devor asserts. (*Id.* at 21-24). Plaintiffs take issue with the weight of this evidence, alleging that securities analysts are generally tools of management insiders who "simply parrot Household management's statements that re-age practices have an economic benefit." (Pl. Br. at 4). There is no evidence in the record for this elaborate conspiracy theory that Plaintiffs posit. Indeed, Plaintiffs pursued this counter-factual theory at Professor Weil's deposition and were immediately rebuffed. (*See* Kavaler Decl. Ex. 16, Weil Tr. 184:11-185:2) ("Q. . . . if this information that you have cited here under question eight was simply analysts relaying to the market the information that Household management had given them in response to the Barron's article, would that effect or impact your reliance on these analysts' reports to support your conclusion? . . . A. You're asking me to assume that professional analysts, without any vetting or checking, write in their reports what management tells them? That is so far at odds with the way I understand analysts' work, that I think it's an absurd hypothetical."). Plaintiffs' baseless speculation of "what if the evidence was not reliable" is no basis to exclude Professor Weil's opinions.

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[4] Professor Weil also considered that Household opened its doors to KPMG to benchmark Household's restructuring policies against the policies of its competitors. (Kavaler Decl. Ex. 15, Weil Rpt. at 23, 29). The results of this study, including KPMG's statement that it "[d]id not encounter evidence that policies benchmarked are designed or applied to manipulate or delay recognition of losses," did not suggest to Professor Weil other avenues of inquiry he could pursue that might be likely to support Mr. Devor's conclusions. (*Id.* at 29)

Professor Weil's methodology for responding to Devor's allegations is perfectly appropriate under Rule 702. Professor Weil applies his unquestioned accounting and economic expertise to evaluate and draw conclusions about the validity of Household's practice of restructuring and supports his independently derived opinions with a showing that it is in accord with industry sources, objective analysts, and independent auditors all agreed with him.

Unlike Mr. Devor, whose "concealment" opinion ignores overwhelming evidence that restructuring was and is a legitimate customer management and collections practice, Professor Weil's analysis of the record included evaluation of documents arguably inconsistent with his conclusion regarding Household's restructuring policies. *See* Fed. R. Evid. 702 advisory committee's note (2000) (citing as a factor for the expert's reliability: "[w]hether the expert has adequately accounted for obvious alternative explanations") (citing *Claar* v. *Burlington N.R.R.*, 29 F.3d 499 (9th Cir. 1994)). For example, he considered the accusations of a former low level employee, Elaine Markell, who questioned Household's restructuring practices. When asked whether he had ignored Elaine Markell's accusations that "restructures were not performed to assist the customer, but rather to make delinquency numbers look more favorable," Professor Weil replied, "No." (Kavaler Decl. Ex. 16, Weil Tr. 178:24-179:25).

Plaintiffs focus on Professor Weil's alleged ignorance of two documents: (1) an analysis of late stage restructures for Household Mortgage Services (a small subsidiary of Household) dated June 11, 2002, and (2) a Wells Fargo due diligence memo dated May 9, 2002. (Pl. Br. at 4-5). This focus is unavailing, however, because its object is the substance of Professor Weil's opinion, not the method that he employed. Plaintiffs know precisely what analysis Professor Weil did, what evidence he considered, and for what purposes. If Plaintiffs believe that Professor Weil should have weighed the evidence differently or should have done additional studies then they are free to make that argument to the jury. *Saad* v. *Shimano American Corp.*, No, 98 C 1204, 2000 WL 1036253, at *4 (N.D. Ill. July 21, 2000) (Schenkier, M.J.) ("[T]he court's gatekeeping function focuses on an examination of the expert's methodology. The soundness of the factual underpinnings of the expert's analysis and the correctness of the expert's conclusions based on that analysis are factual matters to be determined by the trier of fact . . . .").

Moreover, neither document refutes Professor Weil's conclusion that restructuring was a cash flow operational policy. The first document — an internal analysis of the financial per-

formance of accounts with late stage restructures — demonstrates that Household was properly focused on the object of these policies that is completely ignored by Mr. Devor (i.e., improving cash flow). (*See* HHS 01596369-374).[5] Just like the KPMG study discussed above, the mere fact of internal inquiry into cash flow maximization from restructure policy disproves Devor's opinion that the objective of these policies was fraudulent "concealment." If restructuring served no non-fraud purpose, as Devor speculates, then such an analysis would be pointless and potentially embarrassing. Moreover, the study concluded only that ***late stage*** restructures (restructures of customers that are many months delinquent) in one particular loan portfolio did not increase cash flow. Plaintiffs ignore the converse implication of this study that ***early stage*** restructures (restructures of customers that are only a couple months delinquent) do increase cash flow.

With respect to the Wells Fargo due diligence memo, Plaintiffs simply mischaracterize the document. Its observations about Household's restructures are unrelated to the cash flow benefits. Rather, the document states that restructuring an account prevents the foreclosure on the customer's home, which by definition delays the charge-off of the account. As a federally charted depository bank, Wells Fargo is subject to more restrictive restructure charge-off regulations than Household. Although banks are also permitted to restructure delinquent accounts (something else Devor doesn't acknowledge or call "concealment"), banks cannot work with customers as flexibly or as long as a consumer finance company can. The memo addeses what they deemed to be significant costs of converting Household's operations to bank policies if an acquisition went forward. Bemoaning the fact that the hoped-for synergies would cost more than expected has literally nothing to do with whether Household restructured loans in order to deceive investors. Professor Weil's refusal to attribute any significance to the musings of a lay observer from a different regulatory regime on an off-point topic plainly does not qualify his opinion under *Daubert*.

Professor Weil's analysis of Household's policies and practices demonstrates that restructuring was designed to increase cash flow in the aggregate and not to conceal information from investors. Professor Weil clarified this conclusion at his deposition. He testified: "Q. Isn't is im-

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[5] This document also evidences substantial amounts of cash collections from late stage restructured accounts. For example, page HHS 01596381 shows $9.7 million of cash collections, thus providing some evidence that Household's restructuring policies did result in cash collections larger than it would otherwise have collected, which is the very purpose of the restructuring policies.

portant to your opinion whether the manner in which Household restructured its loans actually improved cash flow or increased cash flow? A. No. What's important is that Household thought that it would." (Kavaler Decl. Ex. 16, Weil Tr. 173:19-24). Nevertheless, Plaintiffs state that they would like to have seen Professor Weil calculate the amount of cash flow increased by each customer's restructure. (*See* Pl. Br. at 4 ("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.")).

First, if Plaintiffs (who bear the burden of proof on this issue) recognized the need for an empirical study, they should have commissioned one from their own expert, who provided zero empirical support for his *ipse dixit* opinion. Professor Weil's role was not to prove anything, as Defendants bear no burden of proof on this or any other issue. It was to evaluate the proffered "expert" conclusions of Mr. Devor and provide the Court (and the jury if it came to it) with the tools to determine whether Mr. Devor's opinions are worthy of credit. If the lack of an empirical study is fatal to that mission, as Plaintiffs contend, then their proffer of Mr. Devor should be rejected. Second, the calculation Plaintiffs suggest is impossible to make. It would require knowledge of how each customer would have acted had his loan been treated differently than it actually was. While it is reasonable to believe (as Household did) that many customers are in fact induced to make more payments by the promise of a restructure that makes them current on their loans, there can be no certainty for any given customer that this is true. Household also understood that some restructured customers might have made up all their missed payments without the restructuring help from Household. While it is not possible for Professor Weil or anyone else to discern which was which, Mr. Devor identified no reason to question Household's belief that there were more of the first kind of customer than the second.

Plaintiffs are suggesting that the Company should have foreclosed on certain customers who the Company believed were likely to repay their loans, while offering restructures to others, simply to validate a business policy that management already considered to be successful. Such a suggestion reveals Plaintiffs fundamental misunderstanding of this Company and this case (which is not about the validity of Household's business model or business judgment, *see Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 479 (1977) (noting that proof of mismanagement does not support a claim of securities fraud)), and has literally nothing to do with the admissibility of Professor Weil's expert testimony.

II. PROFESSOR WEIL'S OPINION THAT HOUSEHOLD'S LOSS RESERVES WERE ADEQUATE IS BASED ON RELIABLE METHODOLOGY AND IS HELPFUL TO THE JURY

The proof of the pudding, as they say, is in the tasting. In addition to establishing that restructuring is an operational policy designed to increase cash flow, Professor Weil also performed a proof by contradiction, refuting Devor's allegation that Household's "credit quality concealment techniques" rendered its calculation of its loan loss reserves unreliable (Kavaler Decl. Ex. 17, Devor Rpt. ¶¶ 339, 344, 373, 389-390, 406) because restructured accounts were not adequately considered in the "roll rate" reserve methodology. (*Id.* ¶ 346). First, Professor Weil assumed for purposes of this analysis that restructuring was a "credit quality concealment technique" as Devor posits. He then analyzed what would have happened to Household's financials if it were true that Household was using these policies to "delay charge-offs." He then looked in the record for what should be the resulting indicators.

Professor Weil noted: "If HI engaged in 'credit quality concealment techniques,' then what HI allegedly concealed would reveal itself over time in the form of inadequate allowances for uncollectibles (that is, inadequate reserves)." (Kavaler Decl. Ex. 15, Weil Rpt. at 28). A company can perhaps delay charge-offs for a quarter or two, but after a few quarters of such delays it will have to take a special charge to increase reserves. Therefore, Professor Weil analyzed Household's reserve methodology and statistics to look for any tell-tale consequences of undue charge-off delays. (It bears noting that Mr. Devor, who insists that the function of restructures was to deceive investors about the credit quality of Household's receivables, apparently did not bother to look.) Professor Weil concluded that Household's reserves were adequate throughout the Class Period. The indisputable fact that Household did not have to take a special charge to reserves during the Class Period proves that its reserves were adequate. This is a full stop to Plaintiffs' claims. No charge to reserves means no credit quality concealment. Unsurprisingly, Plaintiffs omit this fact from their brief.

Professor Weil's analysis did not end there. He confirmed his analysis by examining the conclusions of Household's independent external auditors, who concluded that Household's reserves were adequate at all times. (Kavaler Decl. Ex. 15, Weil Rpt. at 37, Exhibit 10). Even Plaintiffs' own accounting expert would not opine that Household's reserves were inadequate (Kavaler Decl. Ex. 18, Devor Tr. 281:22-282:2), although he failed to acknowledge the significance of that

fact. Further evidence of the adequacy of Household's reserves is Professor Weil's comparative analysis of Household's ratios of year-end credit loss reserves to charge-offs, and year-end credit loss reserves to loans receivables/held, against comparable data from eight other subprime lenders over the period 1999-2002. (Kavaler Decl. Ex. 15, Weil Rpt. at 37, Exhibits 3, 3a, 4). Whereas the other analyses that Professor Weil performed were *ex post* evaluations, this analysis is an *ex ante* approach, revealing what the company would have been able to know at the time it was setting the reserves to confirm that its methods were properly accounting for its expected losses. The results show that Household's ratios lie within the ratios of other subprime lenders, which further suggests that Household's reserves were adequate. (*Id.*). Furthermore, the stability of Household's ratio of credit loss reserves to charge-offs over time and its hovering near 1.0 reinforces that conclusion. (*Id.* at Exhibits 3, 3a).

Ignoring all the other evidence, Plaintiffs quibble with Professor Weil's comparative analysis, claiming (without any accounting or legal support) that his study should have included some additional factors, for example, how often each company restructured accounts or how each company went about calculating its reserves. (*See* Pl. Br. at 6-8). Plaintiffs' criticisms miss the point. Regardless of how often a company restructures, if it properly takes those policies into account when setting its reserves (which are a matter of public record) — and if its reserves are always adequate — then by definition it did not conceal the credit quality of its loans. Professor Weil's expert, empirically tested opinion is that the adequacy of Household's reserves throughout the Class Period ***proves*** that the reserves adequately adjusted for restructuring practices and any changes to those practices. (*See* Kavaler Decl. Ex. 16, Weil Tr. 134:20-135:2).[6] It is Plaintiffs' prerogative to disagree with Professor Weil's conclusions or to argue that the jury should consider a different study that their own expert might have performed (had he performed any studies or other expert analysis). Such arguments, however, are properly addressed at trial. *Tyson* v. *Amerigroup*

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[6] Professor Weil's selection of comparable companies also refutes Plaintiffs' false claim that his analysis does not have enough information on these companies' loan receivables and borrower characteristics. (*See* Pl. Br. at 8). Even though Professor Weil cannot know the exact borrower characteristics of the comparable companies from public data, his selection process created a group as close to Household as possible. (Kavaler Decl. Ex. 15, Weil Rpt. at n.64). Furthermore, no matter how many loans Household restructured relative to its peers or how different the companies' policies were, the fact that Household's ratio of year end reserves to charge-offs hovered within the range of other subprime lenders indicates that Household's restructure policies did not act to "conceal" the credit quality of its loan portfolio.

Illinois, Inc., 488 F. Supp. 2d 719 (N.D. Ill. 2007) (Leinenweber, J.) (denying *Daubert* argument that challenged expert did a poor job picking his comparison group for a study). The court noted that the method was reasonable, and added: "The mere fact that Mr. O'Brien failed to consider some variables (that AI wishes he did) is not sufficient to find his methods unreliable under *Daubert*." *Id.* at 733 (collecting cases)).

Following his demonstration that Household's reserves were always adequate, Professor Weil examined the mathematical model that Household used as a starting point in calculating loan loss reserves. He explained that there are two major components, the statistical reserves (via the roll rate methodology) and the judgmental reserves. He even walked through the mathematical calculation that the computer conducts to arrive at the correct number. (Kavaler Decl. Ex. 15, Weil Rpt. at 30-31, Exs. 9, 9a, 9b). Taking quotes from his deposition out of context, Plaintiffs argue that Professor Weil identifies no evidence that Household's reserve methodology included the impact of restructuring. This is false. As Professor Weil explained in his report, the historical component in Household's roll rate model captures the impact of all of Household's policies, including restructuring. (*Id.* at 30-31). Moreover, as his report states, Professor Weil was asked this specific question and gave the following answer:

> "Did HI's 'roll rate' method take into account the impact of re-aging?
>
> Yes. A reaged loan was a loan with its status reset to current. Along with all other current loans, HI reserved a particular amount for these loans. When any of these re-aged loans subsequently became delinquent, HI would set its status to delinquent. The model would reserve for these delinquent loans and all other delinquent loans. Thus, as with any other loan, depending on its delinquency status, a previously re-aged loan would have amounts reserved for the possibility of its being charged off." (*Id.* at 35-36).

Professor Weil's report is replete with the following evidence from the record, which supports his opinion.

- Deposition testimony of Mr. Clifford Mizialko, Assistant Controller: "Q: In 2000 how did your reserve calculations consider the loss experience associated with re-aged accounts? A: In 2000, re-aged accounts were considered as part of the overall roll rate calculation on a product by product basis." (*Id.* at 36) (citing Kavaler Decl. Ex. 19, Mizialko Tr. at 103-108).
- Arthur Andersen memo entitled "HCS Re-age Analysis" states: "Andersen reviewed and considered the effects of re-ages on the owned loan loss reserve methodology. . . . We conclude that the re-age policy for prime and sub prime accounts are reasonable and appropriate." (*Id.* at 36-37) (citing Kavaler Decl. Ex. 24, AA 064627-31).

- Internal Household document: judgmental reserves "reflect(s) management's assessment of the effects of recent trends and current economic conditions on loss rates derived through historical analysis of a pool of loans including bankruptcy trends, growth, changes in mix, amortizing securitizations, recent and expected trends in charge off and delinquency and the impact of collection strategies on the historical roll rates." (*Id.* at 33) (citing Kavaler Decl. Ex. 25, HHS 02022250-256, 02022253) .
- Weil's Report Exhibit 10 lists a number of Household quarterly memoranda titled "Evaluation of the Adequacy of HI Credit Loss Reserves." Those documents contain the following language: "In arriving at the necessary judgmental requirement, the following portfolio risk factors were considered: . . . the level of the re-ages in our portfolio including recidivism and recent trends." (Kavaler Decl. Ex. 26, HHS 03131738-03131747, 03131741).

Attempting to mislead the Court, Plaintiffs ignore these documents, which Professor Weil explicitly relied upon in his Report. Instead, Plaintiffs choose to play a game, claiming that because Professor Weil did not have perfect recall of these documents at his deposition (they did not show them to him) that means he did not consider them. (*See* Pl. Br. at 10). Such tactics reveal the disingenuousness of Plaintiffs' motion.[7]

The misleading nature of Plaintiffs' motion is encapsulated in their misuse of Professor Weil's statement at his deposition that he "would like to have a better answer . . . about the adequacy of reserves . . . ." to imply that he questions the sufficiency of his own methodology. (*See* Pl. Br. at 10). Professor Weil was merely pointing out that the only company-specific analysis that would better prove the adequace of Household's reserves, other than the conclusions of its own auditors which was already done, would be to study the data on Household debits and credits over time, extending over its life until the end of the company's history to see if the time pattern of the debits or credits suitably matched. Because Professor Weil (like the Company) could not possibly have done this, he performed the best feasible analysis of Household's reserve levels. The *Daubert* standard of review is not whether the expert was able to conduct every analysis that he or she could

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[7] Plaintiffs make much of Professor Weil's deposition testimony that he did not perform an analysis of the effects of certain restructuring policy changes on Household's statistical reserve requirement. Notwithstanding the fact that this point is moot because Household's reserves were adequate throughout the Class Period, the documents Professor Weil cites and his deposition testimony, which even Plaintiffs cite, clearly state that significant restructuring changes are not captured in the statistical reserve, but rather in the judgmental reserve. Thus, the analysis Plaintiffs suggest would be meaningless. (*See* Pl. Br. at 9-10). If Plaintiffs disagreed, they could have asked their own expert to conduct this analysis. Mr. Devor reports no such analysis.

conceive, but rather whether the analysis that the expert did conduct was reliable and relevant. Professor Weil's method was both.

III. PROFESSOR WEIL'S OPINIONS CONCERNING THE RESTATEMENT ARE BASED ON RELIABLE METHODOLOGY AND ARE HELPFUL TO THE JURY

On August 14, 2002, Household issued a restatement due to a change in accounting treatment as to four credit card marketing agreements. The restatement was the result of an accounting disagreement between Household's previous accountant, Arthur Andersen, and Household's new accountant, KPMG. To this day, each team of accountants maintains that its own accounting advice was correct.

Evaluating the opinions of Arthur Andersen, KPMG, and others on this esoteric accounting subject, Professor Weil performed an analysis of the accounting for each of the credit card contracts that led to Household's restatement. He concluded that: (1) there was no accounting literature on point at the inception of each of these agreements to indicate that the original accounting was wrong; (2) these complex and ground-breaking credit card contracts caused two prestigious accounting firms reasonably to disagree over the proper method of accounting; and (3) the restatements made at KPMG's insistence are not indicia of fraud. (Kavaler Decl. Ex. 15, Weil Rpt. at Questions 34, 36-38, 43, 45, 48-49, 52). Plaintiffs protest that this last conclusion is inadmissible because "Weil is barred as a matter of law from offering any opinions concerning defendants' state of mind since that determination is a legal question." (*See* Pl. Br. at 12). Plaintiffs misunderstand both Professor Weil's report and the applicable law.

Plaintiffs' own proffered expert, Mr. Devor, has acknowledged that the mere fact of a restatement does not imply fraud (Kavaler Decl. Ex. 18, Devor Tr. 98:3-7). This is consistent with the law that a GAAP violation does not establish fraud. *See Roth* v. *OfficeMax, Inc.*, 527 F. Supp. 2d 791, 797-98 (N.D. Ill. 2007) (Gottschall, J.) ("Importantly, mere allegations of GAAP violations, the restatement of income, or statements regarding the internal controls of a company that are later proven to be false, are not sufficient to demonstrate that those who made the statements committed securities fraud. . . . There must also be . . . scienter."); *In re Bally Total Fitness Securities Litigation*, No. 04 C 3530, 2006 WL 3714708, at *10 (N.D. Ill. July 12, 2006) (Grady, J.) ("Allegations that GAAP or [the company's] internal accounting policies were violated do not establish that the misstatements were made with the requisite intent."); *Ong* v. *Sears, Roebuck & Co.*, No. 03

C 4142, 2005 WL 2284285, at *24 (N.D. Ill. Sept. 14, 2005) (Pallmeyer, J.); *see also In re Ceridian Corp. Securities Litigation*, 542 F.3d 240, 246 (8th Cir. 2008) ("[P]leading an amalgam of unrelated GAAP violations, without more, does not give rise to a strong inference of scienter.").

In view of Plaintiffs' position that the restatement did signify fraud, Professor Weil's testimony explaining the nature and purpose of restatements generally and this one in particular will be of great help to the jury, which might incorrectly conclude that the mere fact of the restatement supports Plaintiffs' position. *See, e.g.*, *United States* v. *Lankford*, 955 F.2d 1545, 1551 (11th Cir. 1992) ("Most jurors would simply lack the specialized knowledge, background, and experience needed to assess the reasonableness of the gift/income tax interpretations . . . ."). Plaintiffs argue that analyzing financial statements and accounting treatments for indications of fraud is not within the duties of an accountant. This is also incorrect. Accounting literature explicitly states that: "'Misstatements can result from errors or fraud. . . ' [Codification of Statements on Accounting Standards, AU § 312.04]" (Kavaler Decl. Ex. 15, Weil Rpt. at 53). Moreover, AU § 316 is titled "Consideration of Fraud in a Financial Statement Audit." *Id.* at 54. And SEC Staff Accounting Bulletin No. 99, which speaks directly to when a restatement is required states:

> SAS 82 requires the auditor to evaluate several fraud 'risk factors' that may bring such misstatements to his or her attention. For example, an analysis of fraud risk factors under SAS 82 must include, among other things, consideration of management's interest in maintaining or increasing the registrant's stock price or earnings trend through the use of unusually aggressive accounting practices, whether management has a practice of committing to analysts or others that it will achieve unduly aggressive or clearly unrealistic forecasts, and the existence of assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties. See AU §§ 316.17a and .17c." (*Id.* at n. 43).

Discussion of the concept of fraud as it relates to accounting analysis of a restatement is something accountants and auditors do all the time. In fact, both of Household's auditors during the Class Period conducted such analyses and agreed that they found no indications of fraud in the restatement accounting.[8] The fact that Professor Weil's opinion happens to directly contra-

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[8] A letter from Arthur Andersen to David Schoenholz following Household's restatement states, "Based on the information provided to us and our review and analysis of the relevant accounting literature, we do not believe that the revision you propose meets the criteria for restatement . . . ." (Kavaler Decl. Ex. 27, HHS 03127913). Minutes of the Special Audit Committee Meeting of Household International dated August 13, 2002 state, "KPMG noted no instances of corporate misconduct, and was satisfied with the integ-

Footnote continued on next page.

dict Plaintiffs' theory of the case does not prevent him from offering it. *See* Fed. R. Evid. 704(a) ("[T]estimony in the form of an opinion or inference otherwise admissible is not objectionable because it embraces an ultimate issue to be decided by the trier of fact.").

Furthermore, it is ironic that Plaintiffs take issue with Professor Weil's opinions as to whether a restatement necessarily implies fraud considering that a full half of Mr. Devor's report is devoted to his conclusion that Household's restructure practices were "credit quality concealment techniques" (Kavaler Decl. Ex. 17, Devor Rpt at 66) that Defendants used for "manipulation of charge-offs" (*Id.* at 117; *see generally id.* at 66-149). If the Court were inclined to permit Mr. Devor to speak to the state of mind of Defendants when implementing policies, *but see Klaczak* v. *Consolidated Medical Transport, Inc.*, No. 96 C 6502, 2005 U.S. Dist. LEXIS 13607, at *31 (N.D. Ill. May 26, 2005) (Filip, J.) ("precedent teaches that proffered expert assertions about another's subjective intent or knowledge are not helpful to the jury, which is equally if not much better suited to make these assessments than the parties' competing paid experts"), then Professor Weil must be permitted to explain to the jury that the relevant accounting literature distinguishes between restatements for error and restatements for fraud, and that a restatement does not on its own imply fraud.

CONCLUSION

For the foregoing reasons, the Court should deny Plaintiffs' motion to exclude certain testimony expected to be offered by Professor Weil.

Footnote continued from previous page.

rity of HI management in making the initial decisions and to resolving this issue with KPMG." (Kavaler Decl. Ex. 28, HHS 03158437-38).

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Respectfully submitted,

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