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

LEAD PLAINTIFFS' RESPONSE TO HOUSEHOLD DEFENDANTS' MOTION BASED ON THE SUPREME COURT'S DECISION IN *DURA PHARMACEUTICALS, INC. V. BROUDO*

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I. INTRODUCTION

The "motion to dismiss" filed by defendants Household International, Inc. ("Household" or the "Company"), Household Finance Corporation, William F. Aldinger, David A. Schoenholz, Gary Gilmer and J.A. Vozar, is based on numerous misperceptions of law and fact. Defendants have already filed motions to dismiss lead plaintiffs' Complaint,[1] which the Court denied on March 19, 2004. *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, No. 02 C 5893 (Consolidated), 2004 U.S. Dist. LEXIS 4659 (N.D. Ill. Mar. 19, 2004). Despite answering the Complaint on July 2, 2004, defendants incorrectly label their motion as a Rule 12(b)(6) motion to dismiss, when in fact it must be treated as a motion for judgment on the pleadings under Rule 12(c).

Besides being procedurally improper, defendants' motion, based upon the recent Supreme Court decision in *Dura Pharms., Inc. v. Broudo*, 544 U.S. __, 125 S. Ct. 1627 (2005), is without merit. In *Dura*, the Supreme Court brought the Ninth Circuit standard for pleading loss causation in securities fraud cases in line with other circuits, including the Seventh. Yet, defendants did not think there was a loss causation issue in their initial motion.

They were right the first time. Consistent with Seventh Circuit law, *Dura* requires only that plaintiffs provide a "short and plain statement" under Fed. R. Civ. P. 8(a)(2) setting forth "what the relevant economic loss might be" and "some indication" of what the causal connection "might be" between plaintiffs' loss and defendants' misconduct (*i.e.*, proximate causation). *Id.* at 1633-34. The Court explicitly declined to adopt the Rule 9(b) particularity standard for loss causation. *Id*. at 1634.

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[1] All references to the "Complaint" and paragraph references herein ("¶") are to the operative [Corrected] Amended Consolidated Class Action Complaint for Violation of the Federal Securities Laws filed on March 13, 2003.

Contrary to defendants' assertions (Defs' Mem. at 6-7),[2] this "causal connection" requirement was embedded in the Seventh Circuit standard ***prior*** to the Supreme Court's *Dura* ruling. *See Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997) (finding that plaintiff alleged "a plausible theory connecting [defendants' misrepresentations] to its loss"); *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 684-86 (7th Cir. 1990) (dismissing complaint for failure to allege a connection between plaintiffs' loss and defendants' misrepresentations). The Seventh Circuit did not follow the Ninth Circuit approach and rejected in *Dura* – that the "inflated purchase price" alone was enough to plead loss causation.

In any event, plaintiffs' Complaint satisfies, and in fact, exceeds the *Dura-Caremark-Bastian* standard. Plaintiffs provided defendants with more than just "some indication" of the "causal connection" between defendants' misrepresentations and the over-arching fraudulent scheme and the corresponding losses incurred by plaintiffs. The Complaint alleges, for example, that as information leaked out about the true state of Household's operations and financial performance that had been concealed by defendants' fraud, such partial revelations caused Household's stock price to decline from as high as $63.25 per share to $20.00 per share by the end of the Class Period (October 23, 1997 through October 11, 2002). ¶¶5-6, 22, 29, 56-57, 140-141, 300, 321, 343-344. Plaintiffs' specific allegations connect Household's stock price declines to numerous revelations of adverse facts concerning defendants' manifold scheme – predatory lending practices, manipulations of delinquency statistics by arbitrary reaging, and other accounting manipulations – the very same issues that defendants had previously misrepresented to the market. *Id.* The Complaint alleges that

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[2] "Defs' Mem." refers to the Memorandum of Law in Support of Household Defendants' Motion to Dismiss Pursuant to the Supreme Court's Recent Decision in *Dura Pharmaceuticals, Inc. v. Broudo*, filed on June 30, 2005.

these partial revelations had the effect of removing the prior inflation from Household's stock price. *Id*. Nothing more is required under *Dura*. 125 S. Ct. at 1633-34.

Defendants' motion is premised on their demand for particularized allegations of explicit "corrective disclosures" directly linked to each aspect of the multi-faceted fraud. Defendants' gambit of attempting to divide and conquer by suggesting three distinct, mutually exclusive frauds, rather than the over-arching single intertwined fraud scheme alleged in the Complaint, is not required by *Dura*, and should also be rejected because it fails to conclude the single-scheme allegations pled in plaintiffs' favor, as required at the pleading stage. *Bethlehem Steel Corp. v. Bush*, 918 F.2d 1323, 1326 (7th Cir. 1990). *Dura* does not even contain the words "corrective disclosure," much less require it. *Dura* and courts interpreting *Dura* have held that loss causation is pled where the complaint contains allegations that provide defendants with "some indication that the drop in [company's] stock price was causally related to [company's] financial misstatements." *See In re Daou Sys., Inc.*, 411 F.3d 1006, 1026 (9th Cir. 2005) *reh'g en banc denied*, Order (9th Cir. Aug. 12, 2005) (Mehdi Decl., Exhibit A);[3] *Greater Pa. Carpenters Pension Fund v. Whitehall Jewellers, Inc*., No. 04 C 1107, 2005 U.S. Dist. LEXIS 12971 (N.D. Ill. June 30, 2005) (J. St. Eve). Remarks and questions posed by the Justices during the *Dura* oral argument demonstrate that the Supreme Court did not accept the argument that fraud can only be revealed by a "corrective disclosure."[4] In fact, the

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[3] "Mehdi Decl." refers to the Declaration of Azra Z. Mehdi in Support of Lead Plaintiffs' Response to Household Defendants' Motion Based on the Supreme Court's Decision in *Dura Pharmaceuticals, Inc. v. Broudo*, filed concurrently herewith.

[4] As *Dura* author Justice Breyer noted at the oral argument, the truth "might come out in many different ways," not simply through an announcement by a corporate executive that "I'm a liar." *Dura Pharms., Inc. v. Broudo*, No. 03-932, 2005 U.S. TRANS LEXIS 4, at *37 (Jan. 12, 2005). In addition, Justice Stevens asked *Dura* counsel:

> What if the information leaks out and there's no specific one disclosure that does it all and the stock gradually declines over a period of 6 months? . . . [M]aybe [plaintiffs] don't know the leaks. The only thing they can prove is that there was a gross false statement at the time

government's *amicus* brief supporting the *Dura* defendants parts company with the *Dura* defendants on this point, stating that "fraud can be revealed by means other than a corrective disclosure." *Dura Pharms., Inc. v. Broudo*, No. 03-932, 2003 U.S. Briefs 932, at *19 (Sept. 13, 2004) ("*Dura Amicus* Brf."). Requiring a "corrective disclosure" would enable wrongdoers to minimize exposure to liability by simply refusing or delaying admission of falsity. *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407 (9th Cir. 1994).

Incredibly, almost three years after the commencement of this litigation, defendants hypothesize that this case is really not a securities fraud case after all, but a "consumer" case masquerading as investor fraud. Defs' Mem. at 4 n.5, 13, 16-20. As a threshold matter, this Court found one and a half years ago that the Complaint alleges securities fraud with particularity. *Jaffe*, 2004 U.S. Dist. LEXIS 4659. Defendants' hypothesis is also belied by the opening sentence of the fact section of their brief – "Household is a leading United States ***consumer lender***." Defs' Mem. at 3.[5] Where the core business of a company is making loans and engaging in other lending-related activity for the purpose of growing revenue and net income, misrepresentations and omissions relating to such core business that impact the financial performance and hence the stock price of the company, are, in fact, securities fraud. *See In re Providian Fin. Corp. Sec. Litig.*, 152 F. Supp. 2d 814 (E.D. Pa. 2001); *see also* ¶¶163-164. Thus, defendants' wrongful conduct here subjects defendants to claims from investors for securities fraud as well as from consumers for the underlying illegal acts.

> they bought the stock and they don't know what happened to the decline. Later on they find out that it gradually leaked out. . . .

Id. at **12-13.

[5] All emphasis is added unless otherwise noted.

Because the Complaint provides a "short and plain statement" alleging plaintiffs' economic loss and "some indication" of the "causal connection" between that loss and defendants' misconduct, defendants' motion must be denied.

II. DEFENDANTS' SECOND MOTION TO DISMISS AFTER ANSWERING THE COMPLAINT SHOULD BE CONVERTED TO A MOTION FOR JUDGMENT ON THE PLEADINGS UNDER FED. R. CIV. P. 12(C)

Defendants filed an initial motion to dismiss in 2003 which this Court largely denied. *Jaffe*, 2004 U.S. Dist. LEXIS 4659. On July 2, 2004, defendants answered the Complaint. Now, a year later, defendants again move to dismiss. But Rule 12(b)(6) motions filed after an answer are construed as motions for judgment on the pleadings pursuant to Fed. R. Civ. P. 12(c). *See Lanigan v. Village of E. Hazel Crest*, 110 F.3d 467, 470 (7th Cir. 1997); *Warzon v. Drew*, 60 F.3d 1234, 1237 (7th Cir. 1995).

Like a Rule 12(b)(6) motion, in considering a Rule 12(c) motion, the court must assume that all facts alleged in the complaint are true, and construe those facts and all reasonable inferences flowing from them in the light most favorable to the plaintiff. *Bethlehem Steel*, 918 F.2d at 1326.[6] A court cannot grant a motion under Rule 12(c) unless the plaintiff can prove no set of facts that

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[6] Defendants attempt to introduce facts outside the Complaint in an effort to challenge plaintiffs' loss causation allegations. *See* Defs' Mem. at 2, 15-16. This tactic is improper at the pleading stage. *See Asher v. Baxter Int'l Inc.*, 377 F.3d 727, 735 (7th Cir. 2004), *certs. denied*, 161 L. Ed. 2d 476 (2005) (finding that the pleading stage was "too early in the litigation" to reach a conclusion about why a stock price declined); *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 99 (2d Cir. 2001) (holding that it was improper at the pleadings stage for district court to accept defendants' competing argument on loss causation). Accordingly, defendants' comparison of Household stock price movement to the Standard & Poor's 500 index without the benefit of expert testimony and event studies explaining price trends, should be rejected. The Supreme Court recognized in *Dura* that there are a "tangle of factors" affecting stock price movements, confirming that discovery and expert testimony are required to make that determination. 125 S. Ct. at 1632. Plaintiffs intend to demonstrate through expert testimony at trial that defendants' competing theory of loss causation is flawed because plaintiffs did, in fact, lose more money investing in Household than investors who invested in the market generally.

would entitle him to relief. *Northern Ind. Gun & Outdoor Shows v. City of S. Bend*, 163 F.3d 449, 452 (7th Cir. 1998).

As detailed below, defendants here have not only failed to demonstrate that plaintiffs can prove no set of facts that would entitle them to relief, but plaintiffs have shown their loss causation pleadings satisfy *Dura*. Thus, defendants' motion should be denied.[7]

III. ARGUMENT

A. Under *Dura*, the Restatement and Accompanying Price Decline Alleged Sufficiently Plead Loss Causation Because the Restatement Reveals that the Overall Financial Condition of Household Was Concealed by Defendants' Multi-Component Fraudulent Scheme to Inflate Revenues Through Predatory Lending, Reaging and Accounting Manipulations

1. To Plead Loss Causation Under *Dura*, Plaintiff Need Only Provide "Some Indication" Under Fed. R. Civ. P. 8(a) of the Causal Connection Between the Loss and the Misrepresentation

In *Dura*, the Supreme Court reversed the Ninth Circuit's pleading rule for loss causation in securities fraud actions, which required that a plaintiff allege only that "the price ***on the date of purchase*** was inflated because of the misrepresentation." 125 S. Ct. at 1634 (emphasis in original).[8] The Supreme Court's holding in *Dura* brought the Ninth Circuit back in line with the loss causation pleading standards of most Circuits – including the Seventh. *Id*. at 1630 (citing *Bastian*, 892 F.2d at 686) (loss causation alleged when plaintiff is harmed by the materialization of risks that plaintiff

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[7] Defendants' attempts to raise, for the second time, the issue of loss causation with respect to plaintiffs' §11 claims, must also fail. Defs' Mem. at 10, n.12. Under Seventh Circuit precedent, "perfunctory and undeveloped arguments . . . are waived." *United States v. Berkowitz*, 927 F.2d 1376, 1384 (7th Cir. 1991). Moreover, "[i]t appears well-settled that loss causation is not a requirement of a cause of action under §11; instead, absence of loss causation is an explicit defense to a §11 claim." *Nielsen v. Greenwood*, 849 F. Supp. 1233, 1247 (N.D. Ill. 1993) (citing *Bastian*, 892 F.2d at 685); *Miller v. Apropos Tech., Inc.*, No. 01 C 8406, 2003 U.S. Dist. LEXIS 5074, at *25 (N.D. Ill. Mar. 31, 2003).

[8] All citations and internal quotations are omitted unless otherwise noted.

believed did not exist); *see also Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 198 (2d Cir. 2003); *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000); *Robbins v. Koger Props.*, 116 F.3d 1441, 1447-48 (11th Cir. 1997). This Circuit has always required an allegation of a "causal connection" between plaintiffs' losses and defendants' misconduct. *See Caremark*, 113 F.3d at 649 ("[T]he requirement is straightforward: The plaintiff must allege that it was in fact injured by the misstatement or omission of which it complains.").[9]

In analyzing the "***pleading***" requirements, the Supreme Court in *Dura* applied Rule 8(a)(2) to pleading loss causation in securities fraud cases. 125 S. Ct. at 1634. Like the defendants here, the *Dura* defendants, and the U.S. Solicitor General as *amicus*, contended that loss causation must be pled with the more stringent particularity requirements of Rule 9(b). Defs' Mem. at 8, 10, 14, 17-18; *Dura Pharms., Inc. v. Broudo*, No. 03-932, 2003 U.S. Briefs 932, at **10-11 (Dec. 22, 2004); *Dura Amicus* Brf. at *15. But, the Supreme Court declined to adopt this standard, stating "neither the Rules nor the securities statutes ***impose any special further requirement in respect to the pleading of proximate causation or economic loss***." *Dura*, 125 S. Ct. at 1634. District courts in this Circuit agree: "The Supreme Court expressly noted that Federal Rule of Civil Procedure 8(a)(2) governs a plaintiff's allegations of loss causation, not Rule 9(b), and that pleading loss causation is 'not meant to impose a great burden upon a plaintiff.'" *Whitehall Jewellers,* 2005 U.S. Dist. LEXIS 12971, at *17 (quoting *Dura*, 125 S. Ct. at 1634). Thus, to successfully plead loss causation, plaintiff must

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[9] Defendants cite *Miller*, 2003 U.S. Dist. LEXIS 5074, and *Danis v. USN Commc'ns, Inc.,* 73 F. Supp. 2d 923, 943 (N.D. Ill. 1999), for the proposition that pre-*Dura* decisions found allegations that the purchase price was "artificially inflated" satisfied loss causation, but both are distinguishable. Defs' Mem. at 6. They involved misrepresentations in initial public offerings, where there was no public market for the securities, and the courts found loss causation sufficiently pled on allegations that had the investing public known the true state of the affairs at the company, it would not have gone public, at least not at the price it did. *Miller*, 2003 U.S. Dist. LEXIS 5074, at *26; *Danis*, 73 F. Supp. 2d at 943.

simply provide "fair notice" by alleging a "short and plain statement" of the loss and "some indication" of the causal connection to the misrepresentations "that the plaintiff has in mind." *Id*.

The Complaint here satisfies the standard for pleading loss causation under both *Dura* and Seventh Circuit precedent. Indeed, the Complaint exceeds *Dura*.

2. Plaintiffs Plead Not Only that They Paid Inflated Prices, but Consistent with *Dura*, Plead that the Inflation in Stock Price Was Removed by Leakage and Partial Revelations Indicating the True Financial Condition of Household Previously Concealed by Defendants' Fraudulent Scheme

As detailed below, plaintiffs have sufficiently alleged a causal connection between defendants' fraud scheme and the loss suffered by plaintiffs. Despite these allegations, defendants stubbornly maintain that plaintiffs' loss causation allegations here are identical to those rejected by the Supreme Court in *Dura*. *See* Defs' Mem. at 1, n.2, 4, 7, 9, n.10. They are not.

Defendants' quotation of language in the Complaint alleging artificial inflation of the stock price proves nothing. *Dura* contemplates pleading ***both*** purchase at inflated prices ***and*** how the inflation was removed. 125 S. Ct. at 1633-34; *Whitehall Jewellers*, 2005 U.S. Dist. LEXIS 12971, at *17 (complaint sufficiently alleged loss causation where plaintiffs had alleged more than inflation of purchase price); *In re Omnivision Tech., Inc.*, No. C-04-2297 SC, slip op. at 11-12 (N.D. Cal. July 29, 2005) (allegation that "Plaintiffs purchased OmniVision securities at artificially inflated prices and suffered damages when revelation of the true facts caused a decline in the value of their investments" was sufficient to allege economic loss). The Complaint pleads both. ¶¶5-6, 22, 28-29, 43, 50, 56-57, 140-141, 300, 321, 343-344, 346-353.

Indeed, defendants conceded at the July 7, 2005 hearing that the inclusion of artificial inflation of stock price language does not invalidate the Complaint. The Court asked: "I take it the Supreme Court didn't find that the inclusion of that language somehow made the complaint invalid."

Mehdi Decl., Ex. B at 6:12-14. In response, counsel for defendants admitted: "No, your honor. It said if that's what they're relying on." *Id.* at 15-16.

Moreover, the Complaint here goes ***well beyond*** pleading price inflation. It provides defendants "fair notice" of the "causal connection" between the misrepresentations, omissions and other fraudulent conduct comprising their scheme, and the corresponding losses incurred by plaintiffs when information about the true state of Household's business operations and financial condition concealed by the scheme leaked out, causing Household's stock price to plummet. Indeed, the six introductory paragraphs of the Complaint alone are sufficient to provide defendants with "fair notice" of "some indication" of this causal connection. *See* ¶¶1-6.

Specifically, the Complaint alleges that during the Class Period, defendants engaged in a single multi-component fraud scheme to mislead the public regarding the true state of Household's business operations and financial performance, which scheme was designed to and allowed defendants to report "record" financial results during the Class Period by, among other things:

(i) engaging in illegal and deceptive lending practices that violated federally mandated disclosure laws and were designed to maximize amounts loaned to subprime borrowers (¶¶2-4; *see also* ¶¶50-106);

(ii) improperly "reaging" or "restructuring" delinquent accounts, thereby manipulating Household's publicly reported financial statistics regarding delinquencies and credit loss reserve ratios so as to make Household's operations and the credit quality of Household's borrowers appear stronger and more profitable than they were (¶¶2-4; *see also* ¶¶107-133); and

(iii) manipulating the accounting for costs associated with the Household's credit card co-branding, affinity and marketing agreements (¶¶2-4; *see also* ¶¶134-155).

The Complaint alleges that defendants' fraudulent scheme "allowed them to artificially inflate the Company's financial and operational results, key financial metrics and risks associated with investing in the Company, including revenues, net income and earnings per share." ¶3; *see also* ¶¶43, 50, 193, 196, 217, 230, 234, 242, 244, 271, 302, 342, 349, 391. In addition, the Complaint

alleges that defendants were only able to access the capital markets and raise crucial funding to run Household's business operations (*i.e.*, selling over $75 billion worth of debt securities during the Class Period) by misrepresenting the credit quality of its loan portfolio. ¶¶3-4; *see also* ¶¶383-394. This Court already concluded that the Complaint alleges defendants' scheme with particularity. *Jaffe*, 2004 U.S. Dist. LEXIS 4659.

The Complaint also pleads the requisite "causal connection" between defendants' scheme and plaintiffs' economic loss: On August 14, 2002, investors began to learn of the true facts about Household's financial and operating condition concealed by the multi-component fraud scheme when defendants were forced to disclose a $386 million restatement resulting in a $600 million charge to earnings. ¶¶5-6; *see also* ¶¶26-27, 50, 134-155. Defendants' pre-market open announcement caused Household shares to immediately plunge $4.71 to $32.09 per share. ¶140.[10] Household stock price dropped even further upon leakage of news of the pending 50-state $484 million settlement with the attorneys general – a revelation directly related to Household's fraudulent predatory lending practices – which resulted in a $525 million charge to earnings. ¶¶6, 29, 56-57, 100, 344. The decline in the price of Household securities reflected the market's realization that, without the ability to continue the fraudulent activities detailed in the Complaint, the Company had lost its "competitive advantage." ¶6. "[P]redatory lending, reaging and accounting manipulations were so central to Household's business model that, as defendants were forced to abandon these illegal practices, the price of Household securities plummeted" to as low as $20.00 per share, 70%

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[10] Defendants' internally inconsistent and fluctuating loss causation theories demonstrate precisely why they are improper at the pleading stage. For example, on the one hand, defendants maintain that a "corrective disclosure" and immediate significant stock price decline is imperative to pleading loss causation. *See* Defs' Mem. at 11 (information important to investors is immediately incorporated into stock prices). On the other hand, where plaintiffs plead an immediate significant stock price decline upon the announcement of the restatement on August 14, 2002 – $4.71 (¶¶140-141) – defendants are quick to dismiss it as an "over-reaction." Defs' Mem. at 16.

below its Class-Period high. *Id*.; *see also* ¶¶21-22, 29, 56-57, 140-141, 321, 343-344. The above allegations more than satisfy the Rule 8 "short and plain statement" notice requirement under *Dura*. 125 S. Ct. at 1634.

But the Complaint alleges far more than *Dura* requires. Not only does it detail precisely how defendants' misrepresentations and omissions caused Household stock to trade at artificially inflated prices during the Class Period, it details the leakage into the market of the truth about Household's business operations. ¶¶5-6, 19, 22, 29, 56-57, 140-141, 209-210, 218-219, 222-224, 233-234, 239-240, 263-264, 272-273, 287-290, 304-305, 321, 324-326, 343-344. It also links the entrance of the partial truth into the market with the removal of the fraud-based inflation in the stock price, thereby showing the causal connection between the fraudulent scheme and plaintiffs' economic loss:

- The cumulative effect of the revelation of defendants' wrongful course of conduct decimated the price of Household shares from a high of $63.25 at the beginning of 1Q02, to around $20.00 at the end of the Class Period. ¶¶6, 29, stock price chart.

- Household's stock price declined from over $53.00 per share in June 2002 to approximately $30.00 per share in late August 2002, as the magnitude and pervasiveness of defendants' fraud leaked to investors. ¶¶21-22.

- Defendants' pre-market open announcement on August 14, 2002 of the restatement caused Household shares to immediately plunge to as low as $32.09 per share – a decline of over $4.71 per share from the prior day's close of $37.80 per share. ¶140.

- Following the filing on August 27, 2002 of the Company's amended FY01 Report on Form 10-K incorporating the restatement, shares of Household continued to trade lower, reaching below $33.00 on September 4, 2002. By October 10, 2002, Household shares reached a seven-year low of $20.65. ¶141.

- Household stock traded $2.75 lower the day after September 2002 *Forbes* magazine released the article: "Home Wrecker; William Aldinger says his Household International succeeds in lending to bad credit risks by managing smarter. People suckered into his mortgages cite other reasons: lies and deceit." ¶¶56-57.

- Rumors of a pending multi-state settlement with the attorneys general to resolve charges of predatory lending caused Household stock to drop from as high as $29.00 on September 30, 2002 to less than $21.00 during early October 2002. ¶344.

- On October 11, 2002, Fitch Ratings placed the Company on Rating Watch Negative and issued a release viewing Household's ability to "replenish[ ] lost revenue resulting from the

implementation of 'Best Practices'" as a challenge that could pressure future profitability. ¶¶100, 169.

Despite the particularity of these allegations, defendants contend that "[t]hese vague allegations offer no specifics," and thus, no notice to defendants. Defs' Mem. at 9, n.11, 14, 17-18. Although *Dura* does not require specifics, plaintiffs' loss causation allegations here are specific, satisfying Rule 9(b). Defendants may choose to turn a blind eye to clear allegations, but the fact remains that, ***unlike in Dura*** where "[t]he complaint[] fail[ed] to claim that Dura's share price fell significantly after the truth became known" (125 S. Ct. at 1634), here the Complaint expressly pleads a significant stock price drop and details how it was "connected" to the defendants' prior false representations regarding the Company's core business, *i.e.*, lending and key performance metrics related to it.

By specifically connecting the stock price declines to the partial revelations of adverse facts leaked to the market about the true financial condition of Household's business, the Complaint more than adequately provides defendants with "some indication of the loss and the causal connection that the plaintiff[s] ha[ve] in mind." *Id.* That is all that *Dura*, *Bastian* and *Caremark* require.

3. Contrary to Defendants' Assertions, *Dura* Does Not Require a Stock Price Drop Tied to a Corrective Disclosure that Explicitly Admits Each of the Alleged Misrepresentations Because that Would Empower Wrongdoers to Immunize Themselves Through Selective Disclosure

Defendants' assertion that plaintiffs must plead a stock drop directly tied to an express "corrective disclosure," misreads *Dura* and is contradicted by *Dura*. *See* Defs' Mem. at 2, 8-20. Nowhere does the Supreme Court require a "corrective disclosure" tied to a stock drop. Indeed, the term "corrective disclosure" does not appear anywhere in *Dura*. The Court instead speaks in terms of the relevant truth, *i.e.*, the true state of the company's finances and operations making its way to the market, thereby eliminating inflation in the stock. *Dura*, 125 S. Ct. at 1631-32. *Dura* quotes Restatement §548A, Comment b, which explains that loss causation is shown when "the facts as to

the finances of the corporation become generally known and as a result the value of the shares is depreciated." Restat 2d of Torts, §548A; *Dura*, 125 S. Ct. at 1633.

Defendants' view of *Dura* is incorrect because they ignore that the Supreme Court expressly declined to adopt a corrective disclosure standard: "We need not, and do not, consider other proximate cause or loss-related questions." 125 S. Ct. at 1633-34. Indeed, in its brief, the Solicitor General arguing as *amicus* in support of the *Dura* defendants, pointedly disagreed with the defendants on this issue stating: "Fraud can be revealed by means other than a corrective disclosure, and a drop in the stock price may not be a necessary condition for establishing loss causation in every fraud on-the-market case. To the extent that courts or litigants have suggested otherwise, they are mistaken." *Dura Amicus* Brf. at *19. The government recognized that requiring a corrective disclosure would enable wrongdoers to immunize themselves from liability simply by "correcting the false information and at the same time issu[ing] unrelated positive information." *Id*. at **19-20; *see also Worlds of Wonder*, 35 F.3d at 1422 (noting that to require a disclosure of the falsity "would eviscerate the statute [because] [c]ompanies and their auditors could immunize themselves from . . . liability for false and even fraudulent financial statements simply by refusing to admit their falsity"). The government also stated that "inflation attributable to a misrepresentation might be reduced or eliminated even if there were a net ***increase*** in price," *Dura Amicus* Brf. at *19 – a scenario the Supreme Court acknowledged, but did not elaborate upon. *Dura*, 125 S. Ct. at 1632.

Courts applying *Dura* have held that there is no requirement that a complaint allege a specific direct disclosure or admission that the prior statements were false. *See*, *e.g.*, *Whitehall Jewellers*, 2005 U.S. Dist. LEXIS 12971, at **15-17 (no requirement that the complaint allege a specific direct disclosure or admission that prior financial statements were in fact false); *Daou*, 411 F.3d at 1026 (rejecting the district court's insistence upon express "negative public statements, announcements or

disclosures," the court held that it was sufficient to allege that "disclosures of the [company's] true financial health" led to a decline in stock price).[11]

For example, *Daou*, like this case, involved allegations that a company repeatedly informed the market that its financial results were better than they actually were. 411 F.3d at 1012-13. The company later revealed that it had "dramatically missed its projected 3Q98 earnings" and suffered deteriorating margins and escalating unbilled receivables, but did not disclose that the company had engaged in improper revenue accounting. *Id.* at 1026. Upon these partial disclosures, the stock price dropped dramatically. *Id.* Reversing the trial court, the Ninth Circuit held that loss causation was sufficiently pled where the stock price dropped following disclosures that the "true financial health" of the company was not what the company had led the investing public to believe, despite the absence of any specific admission that previous financial statements contained falsely inflated revenues. *Id.*

In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 392 (S.D.N.Y. 2003), provides another example. Like here, in the *WorldCom* litigation, certain defendants asserted that loss causation could not be shown because most of the decline of WorldCom, Inc.'s ("WorldCom") stock from over $60.00 a share to near zero took place before WorldCom's admission – at the very end of the class period and only weeks before declaring bankruptcy in July 2002 – that it had overstated income by $3.8 billion. Not until months after the bankruptcy did WorldCom admit that the overstatement actually might exceed $9 billion. And not until March 12, 2004, some 20 months after the bankruptcy, did WorldCom admit that its year 2000 and 2001 financial statements had been misstated by over $74 billion. With WorldCom shares selling for mere pennies by then, the market

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[11] *See also In re Parmalat Sec. Litig.*, Master Docket 04 MD 1653 (LAK), 2005 U.S. Dist. LEXIS 14542, at *98 (S.D.N.Y. July 13, 2005) (loss causation does not, as the defendants would have it, require a corrective disclosure followed by a decline in price).

reaction to an ultimate disclosure simply could not occur. The lack of a stock drop upon that disclosure surely cannot mean that WorldCom investors experienced no loss. To the contrary, it is irrefutable proof that investors paid fraudulently inflated prices for WorldCom securities, and the inflation came out as WorldCom stock inexorably declined prior to the March 2004 disclosure on the heels of truthful bad news entering the marketplace about the company's deteriorating operations.

Defendants' insistence that plaintiffs must allege a bald, corrective disclosure that matches up "apples to apples" and specifically corrects each of the subjects of the earlier misstatements and omissions in the Complaint is not required by *Dura*, and makes no sense. Sophisticated individuals, like defendants here, who choose to commit market manipulation and fraud are likely to be adept at concealing it too. Having deliberately inflated the stock with myriad misstatements, securities-fraud perpetrators may just as easily "walk down" the stock price by the selective disclosure of seemingly unrelated "bad" news concerning the company – avoiding a sudden stock-price reaction, in an effort to insulate themselves from liability. *Worlds of Wonder*, 35 F.3d at 1422. They can reduce, or eliminate, a disclosure's impact on stock price by downplaying its significance or combining it with good news. *Goldberg v. Household Bank, F.S.B.*, 890 F.2d 965, 966 (7th Cir. 1989) (As Judge Easterbrook observed, "a firm that lies about some assets cannot defeat liability by showing that other parts of its business did better than expected, counterbalancing the loss.").

In fact, the Complaint alleges that defendants staggered their disclosure of the adverse information causing Household's stock to decline gradually, rather than collapse suddenly once the revelation of the true state of Household's operations began. ¶¶6, 22, 29, 56-57, 140-141, 300, 343-344. For instance, defendants announced a $386 million restatement on August 14, 2002, resulting in a $4.71 stock price drop. ¶¶140-141. News leakage about the pending 50-state settlement further caused Household's stock price to decline from $30.00 per share in late August 2002, to as low as $20.00 by the first week of October 2002. ¶¶6, 21-22, 29, 56-57, 344. Plaintiffs here have alleged

that defendants' misrepresentations not only caused the fraud, but also concealed the true financial condition of the Company – defendants' reaging manipulations were not only a fraud on the market because they skewed Household's delinquency ratios making the credit quality of Household's customers appear more favorable than it was, they also concealed defendants' predatory lending practices. *See, e.g.*, ¶¶2, 6, 12-15, 20, 24-25, 50, 107-133, 163-164. Defendants' attempts to dissect the Complaint's reaging allegations must, therefore, be rejected. Defs' Mem. at 14-15. Predatory lending and reaging practices were two sides of the same coin. Notwithstanding that complete information about the scope and impact of the reaging practices was not fully disclosed until after the end of the Class Period, the market had already absorbed most of the bad news and taken the inflation out of the stock price by the time of the multi-state attorneys general settlement on October 11, 2002.

In short, defendants' misguided interpretation of *Dura* to require stock drops following explicit corrective disclosures would only empower the very individuals who committed the original fraud, and perversely encourage more misrepresentations and concealment, not less.

Defendants' legal support for an express "corrective disclosure" is also shaky. Defendants rely primarily upon an unpublished Sixth Circuit opinion, *D.E. & J. Ltd. P'ship v. Conaway*, Nos. 03-2334, 03-2417, 2005 WL 1386448 (6th Cir. June 10, 2005), that is currently the subject of a petition for rehearing *en banc*. Indeed, the Sixth Circuit ordered appellees to file a responsive brief suggesting that the court may be re-evaluating its opinion in *Conaway.* Mehdi Decl., Ex. C. Further, as an unpublished opinion, *Conaway*, may not be cited under Seventh Circuit rules. Circuit Rule 53(b)(2)(iv) prohibits citation of unpublished decisions if prohibited in the rendering court. In the Sixth Circuit, which decided *Conaway*, Local Rule 28(g) disfavors citation of unpublished decisions, except where there are no other published opinions on point. As discussed above, in addition to the

Ninth Circuit's *Daou* opinion, there are several other published district court opinions – not to mention *Dura* itself. Citation of *Conaway* is improper.[12]

In any event, *Conaway* is inconsistent with *Dura*, the Ninth Circuit's published opinion in *Daou* and recent Illinois district court decisions, which do not require a "corrective disclosure" explicitly admitting fraud, and instead require only the ***disclosure of the true financial condition*** of the company concealed by the fraud. Thus, defendants' insistence that plaintiffs plead a stock drop tied directly to a disclosure that expressly contradicts the earlier misstatement – an admission that "I'm a liar" for every misrepresentation in the Complaint – is not only unwarranted under *Dura*, but also allows the wrongdoer to evade liability.

In sum, the entire premise of defendants' motion is legally and factually flawed. Thus, it should be denied.

B. The Complaint Alleges a Securities Fraud Case, Not a Consumer Case

Ignoring the fact that this Court, a year and half ago, found that plaintiffs' Complaint alleges securities fraud with particularity (*Jaffe*, 2004 U.S. Dist. LEXIS 4659), defendants posture at length that this is a consumer case, not securities fraud. Defs' Mem. at 4, n.5, 17-18. As with their interpretation of *Dura*, defendants ignore facts adverse to their position. Misrepresentations about the core business operations of a company necessarily impact the financial performance and hence the stock price of the company. *See*, *e.g.*, *Providian*, 152 F. Supp. 2d at 817-18 (allegations that

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[12] The only other cases mentioned in passing by defendants, *In re Initial Pub. Offering Sec. Litig.*, MDL 1554 (SAS), 2005 WL 1162445 (S.D.N.Y. May 6, 2005), and *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005), are distinguishable. Defs' Mem. at 8, 9-10 n.11,14. In the *IPO* cases, the court found that plaintiffs did not allege that defendants' fraudulent scheme was "ever disclosed; thus failing to plead loss causation." *In re Initial Pub. Offering Sec. Litig.*, MDL 1554 (SAS), 2005 U.S. Dist. LEXIS 9318, at *17 (S.D.N.Y. May 16, 2005). *Lentell* was concerned with a unique situation in which the underlying financial condition of the company – which occasioned the price drop – had never been concealed from investors. 396 F.3d at 175. Rather, the false statements on which plaintiffs based their claims had to do with the analysts' alleged conflicts of interest in recommending the stock earlier in the class period. Neither that conflict, nor the analysts' underlying "true" opinion that had been concealed, caused the stock drop. *Id.* at 175-76.

Providian Financial Corporation ("Providian), a subprime money lender had engaged in a series of illegal or fraudulent lending practices that permeated its core business and resulted in artificially inflating the company's financial results stated a claim for securities fraud); *Asher v. Baxter Int'l, Inc.*, Case No. 02 C 5608, 2005 U.S. Dist. LEXIS 2131, at *26, n.8 (N.D. Ill. Feb. 3, 2005) (problems with sales of a product comprising even 25% of Baxter's sales would no doubt have been recognized as having a negative effect on Baxter's overall sales numbers).

The Complaint alleges that consumer lending accounted for the overwhelming majority of the Company's revenue. ¶164. Household's Securities and Exchange Commission ("SEC") filings and other public disclosures also admit that Household through its subsidiaries "primarily provide[s] middle-market consumers with several types of loan products," including real estate secured loans, auto finance loans, credit cards, and other types of secured and unsecured loans. Affidavit of Thomas J. Kavaler in Support of the Household Defendants' Motion to Dismiss Pursuant to the Supreme Court's Recent Decision in *Dura Pharmaceuticals, Inc. v. Broudo*, Ex. B at 2. Household's SEC disclosures demonstrate further that in 2002, its total managed receivables of $107.5 billion from its three reportable segments (Consumer, Credit Card and International) were from loans and other forms of lending activity, with the consumer segment alone at 75% (or $80.4 billion). Mehdi Decl., Ex. D at 6-8. Household's total owned receivables of $82.56 billion were also generated from loans and lending-related activity. *Id*.[13] The same is true during the entire Class Period.

In *Providian*, the court concluded that the pleadings sufficiently alleged a securities fraud violation (152 F. Supp. 2d at 817), finding that the complaint's allegations that Providian realized

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[13] Defendants have conveniently omitted these two pages from their submission to the Court, while submitting an affidavit claiming that Exhibit B attached to Thomas Kavaler's Affidavit is a "true and correct copy" of Household's Form 10-K filed on March 25, 2003.

revenue and profits generated from its illegal or fraudulent business practices related to a core aspect of Providian's business, but the financial statements that reported Providian's results made no mention of these practices, instead attributing the results to Providian's "customer-focused approach":

> Having put the issue in play, Providian is obligated to disclose information concerning the source of its success, since reasonable investors would find that such information would significantly alter the mix of available information. . . . ***Were Providian engaged in a series of illegal or fraudulent business practices and were those practices responsible for inflating revenue, profit, and the customer base, such information would clearly alter the mix of information available to the public as to the source of Providian's success and the viability of full realization of Providian's reported profits***. . . .

Id. at 824-25.

As in *Providian*, the Complaint here alleges that defendants, throughout the Class Period, attributed Household's income and revenue successes to its ability to use (1) centralized and highly automated underwriting, collection and processing functions to adapt credit standards and collection efforts to national or regional market conditions; and (2) proactive credit management, "hands-on" customer care and targeted product marketing to retain customers and grow business. ¶¶12, 41, 113, 303; *see also Evergreen Fund, Ltd. v. McCoy*, Case No. 00 C 0767, 2000 U.S. Dist. LEXIS 16876, at **6-7, 18 (N.D. Ill. Nov. 6, 2000) (allegations that company's widespread Truth in Lending Act violations, including improper billing procedures and charging of excessive late fees and interest to its credit card customers, were material to the overall financial condition of the company, and clearly alleged a connection between revenue-related disclosures and a drop in stock value). Defendants' repeated contentions that "the Complaint is actually nothing more than an effort by Plaintiffs' counsel to masquerade such 'customer' claims as a 'fraud' against investors," therefore ring hollow. Defs' Mem. 4 n.5, 17-18. Here, as in *Providian*, the defendants' wrongful conduct gave rise to claims from both investors ***and*** consumers.

Defendants also contend that the Complaint does not allege "investors were unaware of the nature of Household's business and the regulatory scrutiny and risks associated therewith," or "of the existence of various consumer lawsuits against the Company before such lawsuits were settled." *Id*. at 18-19. But whether the market knows the "truth" is a fact issue for summary judgment or trial, not the pleading stage. *Asher*, 377 F.3d at 735; *see also Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 167 (2d Cir. 2000) ("The truth-on-the-market defense is intensely fact-specific . . . ."); *Provenz v. Miller*, 102 F.3d 1478, 1493 (9th Cir. 1996) (finding that summary judgment is proper on the truth-on-the-market defense only if defendants "show that 'no rational jury could find' that the market was misled"). Here, the Complaint alleges that defendants concealed the truth: defendants attributed Household's dramatic success to management's savvy business acumen, and at the same time minimized the impact of the consumer lawsuits on the Company's financial performance, instead representing to investors: "For 124 years, we've set the standard for responsible lending. And now we're doing it again"; "We make good loans that not only are legal loans, but are beneficial for our customers"; and "Our position is that the accusations [regarding predatory lending] are baseless . . . . ***The loans are legal, they are compliant with state and federal laws and our own policies, and in each instance they have benefits for each customer***. . . . The loan[s] conform[] to the company's 'tangible benefits test.'" ¶¶20, 88, 329; *see* ¶¶83-96, 266, 280, 301, 317; *see Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 281-82 (3d Cir. 1992) (Management practices need not necessarily be disclosed under securities laws, but where a bank characterizes its management practices as "conservative" and "cautious," the bank puts the issue of management practices "in play" and is bound to speak truthfully about the practices.).

Just as in *Providian* the separate existence of the consumer suits only bolsters the finding of securities fraud here.

IV. CONCLUSION

Because the Complaint meets the requirements for pleading loss causation set by the Supreme Court in *Dura*, 125 S. Ct. 1627, by alleging more than a "short and plain statement," setting forth "what the relevant economic loss might be" and "some indication" of what the causal connection "might be" between plaintiffs' loss and defendants' misconduct, defendants' motion should be denied.

DATED: August 18, 2005

Respectfully submitted,

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