IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

LAWRENCE E. JAFFE PENSION PLAN, On Behalf of Itself and All Others Similarly Situated,	)	Lead Case No. 02-C-5893 (Consolidated)
Plaintiffs,	)	
v.	)	**Hon. Ronald A. Guzman** Magistrate Judge Nan R. Nolan
HOUSEHOLD INTERNATIONAL, INC., et al.,	)	
Defendants.	)	

MEMORANDUM OF DEFENDANT ARTHUR ANDERSEN LLP
IN SUPPORT OF PROPOSED SETTLEMENT WITH THE PLAINTIFF CLASS

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Defendant Arthur Andersen LLP ("Andersen") submits this memorandum, pursuant to the Court's Order of January 17, 2006, in support of the Lead Plaintiffs' motion seeking approval of the proposed settlement between Andersen and the plaintiff class. The settlement agreement is set forth in a Stipulation of Settlement between Andersen and the Lead Plaintiffs, dated as of June 16, 2005. The parties have agreed to settle this matter, subject to the Court's approval, on terms that include Andersen's payment of $1.5 million in cash into a settlement fund and Andersen's agreement to cooperate with the Lead Plaintiffs in providing relevant, non-privileged information for the Lead Plaintiffs' continued litigation of this matter against the non-settling defendants. See 6/16/05 Stipulation, ¶¶ 2.1-2.3.

Introduction and Summary of Position

The proposed settlement between Andersen and the plaintiff class was reached after years of hard-fought litigation, and only after the parties participated in a mediation before Judge Layn Phillips, a respected jurist who has mediated previous cases involving Andersen. The settlement agreement would not have been possible without that mediation process and Judge Phillips' direct involvement in forcing the parties to take a hard look at the strengths and weaknesses of their case. The settlement agreement was reached through arms-length negotiations conducted in the context of a fair and open mediation process.

Andersen submits that the proposed settlement is fair, reasonable and adequate, and meets all of the requirements for approval by this Court. The fairness of the settlement is shown by the following considerations, among others:

- **Most of Plaintiffs' claims have nothing to do with Andersen, and the Plaintiffs and class would remain free to pursue those claims against the non-settling Household Defendants—with Andersen's cooperation—after approval of the settlement with Andersen.**

For part of the class period, Andersen served as Household's outside auditor. The *only* representations Andersen made were contained in its audit reports, which opined solely on whether Household's year-end financial statements, taken as a whole, were presented fairly in all material respects, based on the tests conducted by Andersen. Most of Plaintiffs' claims have nothing to do with Household's year-end financial statements or Andersen's audit reports. Rather, Plaintiffs allege that during the class period, "Household was engaged in a massive

predatory lending scheme," using "a variety of illegal sales practices and improper lending techniques." Cmplt. ¶¶ 2-3. According to Plaintiffs, the extent of Household's alleged predatory lending practices was concealed from the market until October 11, 2002, at the end of the class period—and after the period covered by Andersen's audits—when Household agreed to pay $484 million to settle lawsuits brought by the Attorneys General of a number of States. Cmplt. ¶ 23. Although Plaintiffs have argued that Andersen should have predicted this post-audit-period liability, or predicted that Household's prior earnings could not be repeated, by uncovering and disclosing Household's alleged predatory lending scheme, this argument misconceives the role of an auditor.

Andersen's audit opinions contained no representations—one way or the other—regarding the fairness or legality of Household's underlying loan transactions with consumers, nor would an auditor be expected to (or competent to) review the millions of underlying consumer loans for compliance with various state *legal* requirements. Because Andersen never vouched for the fairness or legality of Household's dealings with its customers, Plaintiffs have no claim against Andersen based on *Household's* purported failure to disclose its alleged "predatory lending" practices.[1] Any such claim must be brought against Household, and Plaintiffs will be able to pursue that claim, with Andersen's cooperation, after approval of the proposed settlement.

- **Were the case against Andersen to go forward, Plaintiffs would be unable to prevail on their only claim with a nexus to Andersen's audit opinions because Plaintiffs cannot establish (among other elements) either scienter or loss causation.**

As to the one matter that does implicate Andersen's audit opinions, a retroactive change in Household's cost amortization accounting after Household hired new auditors, the restatement clearly arose from a good-faith disagreement among auditors regarding a complex matter of professional judgment, specifically whether new GAAP guidance should be applied retroactively to change the amortization periods under existing contracts, or only on a prospective basis. Such

[1] Indeed, this claim does not impact the financial statements at all; plaintiffs' claim is not that Household's earnings were not real (they were, as demonstrated by the fact that the successor auditor did not mandate the restatement of the earnings reported on the financial statements audited by Andersen based on "predatory lending") but that the earnings could not be repeated in the future because they were based on Household's wrongdoing. Disclosures as to the risk factors or trends affecting business results, or factors that might cause future performance to differ from past reported results, are required to be made by company management, not the outside auditors.

a technical disagreement is hardly a sufficient basis for a charge of fraud, and Plaintiffs will be unable to show that Andersen did not honestly believe—and continue to believe—in the correctness of the original accounting. Moreover, the financial effect of the restatement was modest. In fact, when Household announced its restatement, the market yawned, and the stock closed slightly *higher*. Absent a market decline, Plaintiffs will be unable to prove that any statement by Andersen caused the losses of which they complain.

- **The proposed settlement is fair, reasonable and adequate given the weakness of Plaintiffs' claims against Andersen and the value of Andersen's cooperation in Plaintiffs' prosecution of the more significant claims against the Household Defendants.**

For the reasons mentioned above (and others discussed more fully below), Andersen does not believe that it faces substantial risk of liability or significant damage exposure in this case. The settlement payment agreed to by Class Plaintiffs and their experienced counsel fairly (and accurately) reflects the weakness of Plaintiffs' claims against Andersen. But the proposed settlement does more than provide money to the class; it also provides for cooperation with the Plaintiffs as they pursue their claims against the Household Defendants. Cooperation is a form of consideration for the settlement that was valued by the experienced counsel representing the class.

- **The proposed settlement is fair, reasonable and adequate given the practical difficulties Plaintiffs would face in pursuing protracted litigation against Andersen.**

Plaintiffs face practical difficulties in pursuing their claims against Andersen, as well. This suit is already nearly four years old and unlikely to be tried before 2007, at the earliest. As Plaintiffs' counsel concluded, the interests of the class would be better served by an early resolution of their claim against Andersen, through a settlement providing for a monetary payment plus cooperation, than by the protracted delay that will be inevitable if Plaintiffs insist on taking their weak claim against Andersen to trial.

As is well known, Andersen today is in a position markedly different from that of most, if not all, other litigants. Andersen's business was destroyed by the decision of the U.S. Department of Justice in March 2002 to indict the firm on a charge of obstruction of justice. *See Roquet v. Arthur Andersen LLP*, 398 F.3d 585, 587-88, 590 (7th Cir. 2005) (observing that the indictment was an "unprecedented cataclysmic event" that "triggered massive client defection,"

"economic hemorrhaging" and the forced layoffs of thousands of employees). Although the Supreme Court eventually reversed Andersen's conviction (*see Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005)), the damage had been done.

The Declaration of John O. Niemann, Jr., Andersen's President and Chief Operating Officer, filed under seal herewith, provides detailed and confidential information regarding the billions of dollars in the aggregate sought by plaintiffs in law suits pending against Andersen, and the limited resources Andersen has available to resolve those matters. Moreover, Andersen does not have any insurance coverage for this law suit or a number of other pending suits. Niemann Decl. ¶ 4. Many of those cases—including significant cases—are likely to be resolved before this case.

Andersen is engaged or anticipates becoming engaged in settlement discussions with many plaintiffs in many cases. Not only the Class Plaintiffs here, but other litigants, as well, have recognized the practical realities of Andersen's position, and seen the wisdom of settling their claims for a small fraction of the claimed damages in order to achieve an early resolution. Indeed, the proposed settlement here is consistent with what Andersen has paid in other cases settled after March 2002, particularly where there was no insurance coverage. Niemann Decl. ¶ 6. The amounts of those other settlements confirm the reasonableness of the proposed settlement here—particularly so given that this is only a partial settlement and that Andersen has offered additional value by cooperating with Plaintiffs in their claims against the non-settling defendants.

Argument

I. THE PROPOSED SETTLEMENT IS FAIR, REASONABLE AND ADEQUATE GIVEN THE WEAKNESS OF PLAINTIFFS' CLAIMS AGAINST ANDERSEN.

In determining whether a proposed settlement is fair, reasonable and adequate, the Seventh Circuit has instructed that "the most important consideration" is "the relative strength of plaintiffs' case on the merits as compared to what the defendants offer by way of settlement." *Isby v. Bayh*, 75 F.3d 1191, 1199 (7th Cir. 1996). Here, most of Plaintiffs' claims simply have nothing to do with Andersen or its audit opinions, but rather implicate alleged statements or omissions by the non-settling Household Defendants. The proposed settlement leaves Plaintiffs free to pursue these claims against the Household Defendants, with Andersen's promised cooperation. Moreover, the only claim that does touch upon Andersen's audit work is

extraordinarily weak. Among other deficiencies, Plaintiffs will be unable to establish at least two required elements, loss causation and scienter. As Plaintiffs' counsel concluded, the proposed settlement, in which Andersen offers both financial consideration and additional consideration in the form of cooperation with Plaintiffs, is eminently fair, reasonable and adequate.

"[T]he fact that experienced counsel involved in the case approved the settlement after hard-fought negotiations is entitled to considerable weight." *Ellis v. Naval Air Rework Facility*, 87 F.R.D. 15, 18 (N.D. Cal. 1980), *aff'd*, 661 F.2d 939 (9th Cir. 1981). See also *McDonald v. Chicago Milwaukee Corp.*, 565 F.3d 416, 426-27 (7th Cir. 1977). This is particularly so here, where Plaintiffs are represented by experienced securities class action lawyers—lawyers who have achieved billion-dollar settlements in other cases—and where the settlement was approved as reasonable not only by Plaintiffs' lawyers but by the respected judge who acted as an impartial mediator.

A. Most of Plaintiffs' Claims Have Nothing To Do With Andersen.

Household is a financial services holding company whose operating subsidiaries, during the class period, provided a variety of consumer loan products to a customer base primarily composed of "nonconforming, nonprime or subprime consumers." Cmplt. ¶ 8. Plaintiffs allege that during the class period, "Household was engaged in a massive predatory lending scheme," using "a variety of illegal sales practices and improper lending techniques." Cmplt. ¶¶ 2-3. According to Plaintiffs, the extent of Household's alleged predatory lending practices was concealed from the market until Household agreed to pay $484 million to settle lawsuits brought by the Attorneys General of a number of States on October 11, 2002, at the end of the class period. Cmplt. ¶ 23. Plaintiffs also allege that Household improperly "reaged" or "restructured" delinquent accounts, thereby creating the appearance that the credit quality of Household's borrowers was more favorable than it actually was. Cmplt. ¶ 2. Whether or not these claims are cognizable against the Household Defendants, they simply are not viable claims against an outside auditor.

For part of the class period, namely the years 1997-2001, Andersen served as Household's outside auditor. The only representations Andersen made relating to Household were its audit reports on Household's 1997-2001 year-end financial statements. See Cmplt. ¶¶

173, 174, 202, 227, 249, 279, 316. In its audit opinions, Andersen opined on the material fairness of Household's consolidated financial statements under Generally Accepted Accounting Principles ("GAAP"). See Cmplt. ¶ 174 (quoting audit opinion). Andersen made *no statements* in those audit reports that related in any way to the fairness or propriety of Household's lending arrangements with consumers, nor was it Andersen's role as an auditor to do so.[2] Where an auditor has not expressed an opinion, it cannot have violated Section 10(b) of the Securities Exchange Act of 1934. See, e.g., *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *Shapiro v. Cantor*, 123 F.3d 717, 721 (2d Cir. 1997); *Danis v. USN Communications*, 121 F. Supp. 2d 1183, 1193 (N.D. Ill. 2000). In short, most of Plaintiffs' claims have nothing to do with Andersen.

1. Plaintiffs Would Be Unable To Prevail On A Claim Against Andersen Regarding Household's Alleged "Predatory Lending."

The role of an auditor, particularly under the professional standards governing at the time of the Household audits, was to issue an opinion on the audited financial statements, not to function as some sort of all-purpose compliance officer reviewing the company's transactions for legality or fairness to customers. As the Seventh Circuit stated in *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990), "[a]lthough accountants must exercise care in giving opinions on the accuracy and adequacy of firms' financial statements, they owe no broader duty to search and sing."

As the complaint concedes, Andersen's audit opinions addressed solely the material accuracy of Household's audited financial statements, and not the "fairness" of Household's transactions with consumers. The audit opinions, which are quoted in the complaint, stated that Andersen had concluded, based on its audit procedures, that Household's audited year-end financial statements "present fairly, in all material respects, the financial position of Household" for the covered period, in conformity with GAAP. *See* Cmplt. ¶ 174 (quoting audit opinion). The complaint's "predatory lending" allegations (Cmplt. ¶¶ 51-106) fail to link the alleged business practices to any material error in Household's audited financial statements. Plaintiffs were unable to allege, and would be unable to prove, that the alleged practices caused

[2] Indeed, plaintiffs' 153-page complaint barely mentions Andersen. The entirety of the allegations relating to Andersen's alleged accounting errors make up only *ten* of the 398 paragraphs of the complaint. See Cmplt. ¶¶ 182-91. In contrast, plaintiffs' allegations relating to Household's alleged "predatory lending" practices and reaging of delinquent accounts consume over *fifty pages*. See, e.g., Cmplt. ¶¶ 51-153.

Household's year-end financial statements to be materially in error during the class period. Nor would Plaintiffs be able to show that the practices were so widespread or pervasive that the risk of civil liability was sufficiently likely—and that the amount of such liability could be reasonably estimated—to allow the company to establish a loss contingency reserve during the time periods covered by Andersen's audits. *See* Cmplt. ¶ 104 (acknowledging that Statement of Financial Accounting Standards ("SFAS") No. 5, Accounting for Contingencies, provides that a loss reserve can be established for a contingent liability only "when the estimated loss is probable and reasonably estimated").

Were the litigation against Andersen to continue, Plaintiffs could be expected to point to the fact that Household ultimately agreed to a settlement with the States' Attorneys General of alleged predatory lending claims (the "AG Settlement"). The complaint admits, however, that the AG Settlement took place in the fourth quarter of 2002—*after* the period covered by Andersen's audits. *See* Cmplt. ¶ 5. Household accounted for the settlement as a charge against the company's earnings in 2002, and Plaintiffs would be unable to prove that the settlement should have (or could have) been accounted for in any earlier period. After all, KPMG, Household's successor auditor, did *not* recommend that Household restate any prior period financial statements as a result of the AG Settlement. The concurrence of the successor auditor refutes Plaintiffs' claim that there was fraud by Andersen. *See Ikon Office Solutions Sec. Litig.*, 277 F.3d 658, 669 (3d Cir. 2002) (fact that another accounting firm decided that restatement was not necessary "undermines any suggestion that [the prior auditor] could not reasonably have opined that [the company's] financial statements fairly presented its financial condition in accordance with GAAP").

Plaintiffs' theory that Andersen should have predicted the likelihood and amount of the liability Household might incur from the alleged "predatory lending" practices (apparently by reviewing the underlying consumer loans for compliance with various state legal requirements) not only misconceives the role of an outside auditor, it is also a blatant attempt to allege "fraud by hindsight." Although Household was subject to several law suits and charges of predatory lending in 2001, *unproven allegations* in lawsuits—which were denied by the company—are hardly probative, and an auditor is not in a position to reach a conclusion as to the legal merits of such disputed claims, much less to predict the likely outcome of the litigations (which were disclosed to the market by the company). Andersen's failure to predict the AG settlement could

hardly amount even to negligence, much less fraud. *See, e.g., Kushner v. Beverly Enterprises, Inc.*, 317 F.3d 820, 827 (8th Cir. 2003) (rejecting securities fraud claim predicated on alleged failure to establish sufficient reserves to cover a subsequent civil settlement because without allegations of particular facts showing that defendants "knew the financial statements overrepresented the company's true earnings" "at the time they made their statements," "a showing in hindsight that the statements were false does not demonstrate fraudulent intent"). As the Seventh Circuit instructed in *DiLeo*, "[t]here is no fraud by hindsight." *DiLeo*, 901 F.2d at 628 (quoting *Denny v. Barber*, 576 F.2d 465, 470 (2d Cir. 1978)).

Because Plaintiffs would be unable to prove that Andersen's audit opinions were even false by virtue of Household's alleged predatory lending activities, much less that Andersen knew of or recklessly disregarded some material error in the audited financial statements, Plaintiffs have no viable claim against Andersen based on their theory that Household engaged in "predatory lending" practices.

Moreover, because Andersen never publicly claimed to have reviewed Household's millions of consumer loans to determine whether the terms were "fair," and never provided an opinion certifying Household's compliance with whatever laws may have governed Household's lending activities, Plaintiffs could prove no claim against Andersen based on *Household's* purported failure to disclose its alleged "predatory lending" practices. *See, e.g., Shapiro*, 123 F.3d at 721 (auditor not "responsible for the company's public statements" as to which the auditor issued no opinion, even if "the accountant may know those statements are likely untrue"); *Danis*, 121 F. Supp. 2d at 1193 (rejecting §10(b) claim against auditor based on company's "unaudited reports" that the auditor reviewed); *Tricontinental Indus. v. Anixter*, 184 F. Supp. 2d 786, 788 (N.D. Ill. 2002) (auditor not liable for "the statements of others" as to which the auditor has not issued an opinion).

As the Second Circuit explained in *Wright*, 152 F.3d at 175, holding an auditor liable for the statements of the company where the auditor had made no public statement regarding the matter would "effectively revive aiding and abetting liability under a different name" and run afoul of the Supreme Court's holding in *Central Bank v. First Interstate Bank*, 511 U.S. 164, 177 (1994), that Section 10(b) does not authorize a claim against aiders and abetters to securities fraud. Here, as well, because Andersen made no statements regarding the "fairness" of

Household's consumer loans, and because Plaintiffs would be unable to link Household's purported "predatory lending" practices to an error in the one statement Andersen made—its audit opinions on the financial statements—Plaintiffs would be unable to prove a claim against Andersen based on their "predatory lending" theory.

2. Plaintiffs Would Be Unable To Prevail On A Claim Against Andersen Based On Household's Alleged "Reaging" Of Accounts.

Plaintiffs' allegations regarding Household's reaging of delinquent accounts barely mention Andersen, and provide no facts to suggest that Andersen was aware of, or recklessly disregarded, any material error in Household's audited financial statements. Were the litigation against Andersen to continue, Plaintiffs would be expected to argue that Andersen should have detected, through sampling, that a certain percentage of Household's accounts had been reaged multiple times, and that KPMG, Household's subsequent auditor, supposedly identified these alleged facts and "caused Household" to disclose its reaging statistics. But even if KPMG did "require" Household to break out its reaging statistics beginning in the second quarter of 2002 (and Andersen has no knowledge of that), this cannot show that the failure to do so earlier was fraudulent. *See Comshare Sec. Litig.*, 183 F.3d 542, 553 (6th Cir. 1999) ("[M]ere allegations that statements in one report should have been made in earlier reports do not make out a claim of securities fraud."). Indeed, Plaintiffs could hardly suggest that KPMG believed Household's reaging practices caused the year-end financials audited by Andersen to be in material error, given the fact that KPMG did *not* require that Household restate any prior period financial statements based on the reaging issue. On the contrary, the notion that KPMG "required" a separate disclosure of reaging statistics *going forward*, and did *not* require a restatement, completely undercuts Plaintiffs' claim against Andersen. KPMG specifically looked at the matter and determined that a restatement was not appropriate. Thus, Plaintiffs can hardly show that Andersen's accounting judgments were fraudulent rather than (at most) merely mistaken. See *Riggs Partners, LLC v. Hub Group, Inc.*, 2002 WL 31415721, at * 9 (N.D. Ill. Oct. 25, 2002) (to establish scienter against an outside auditor, plaintiffs must show that "no reasonable accountant would have made the same decisions if confronted with the same facts"). *See also Ikon*, 277 F.3d at 669 (fact that another accounting firm concluded that restatement was not necessary undermines inference of scienter as to prior auditor).

Here again, Plaintiffs' "reaging" argument also misconstrues the role of an auditor. An auditor opines on the material fairness of the financial statements taken as a whole. Andersen provided no opinion concerning Household's reaging practices or statistics. Nor is there anything inherently wrong or fraudulent with the reaging or restructuring of delinquent accounts. Reaging, which is a practice whereby delinquent accounts are reset to current status when certain criteria are satisfied (see Cmplt. ¶ 110) is common in the consumer finance industry, particularly when dealing with subprime borrowers, and allows the lender to work with customers facing financial difficulty in order to preserve customer relationships and ultimately maximize collections. The issue for the auditor is simply whether the company takes the reaging into account in setting adequate loan loss reserves so that the company's net income is not misstated. Plaintiffs did not allege any facts in the complaint to suggest, and they would be unable to prove, that Household's loan loss reserve was inadequate during the period covered by Andersen's audits. The fact that Household has never been forced to take a substantial writeoff of delinquent loans is powerful—if not dispositive—evidence that there is no claim against the auditor based on Household's loan loss reserve. Moreover, KPMG obviously did *not* conclude that the loan loss reserve was inadequate, inasmuch as KPMG did not determine that the reserve should be restated.

But even if Plaintiffs could show that Household's reaging practices caused a material error in some financial statement audited by Andersen—and they cannot—such a showing would be insufficient, by itself, to establish scienter. After all, "[t]he failure to follow GAAP is, by itself, insufficient to state a securities fraud claim." *Comshare*, 183 F.3d at 553. Plaintiffs would presumably argue that Andersen could have detected a discrepancy in Household's delinquency rates by examining some undefined sample of the millions of underlying loans and discovering that some loans had been reaged arbitrarily. But Plaintiffs would be unable to cite any professional standard to show that an auditor is required to engage in such an exercise, much less why the failure to do so (if such a review were required by applicable professional standards) would amount to anything more than simple negligence, rather than fraud.

Plaintiffs could be expected to argue that Household entered into a consent order with the SEC that found that *Household* had made false and misleading statements regarding its reaging practices. This argument fails to support a claim against Andersen, which was not even a party to the consent order. Moreover, although the consent order stated the SEC's position that

Household in certain of its public statements did not adequately describe its reaging practices, the SEC did *not* contend that Household's reaging practices were arbitrary or improper; the SEC did *not* claim that Household's loan loss reserves were calculated in violation of GAAP or that they should have been higher; the SEC did *not* require or even recommend that Household restate any financial statements; and the SEC did *not* require Household to write off any loans or to take larger loan loss reserves. Thus, if the consent order has any relevance at all, it refutes rather than supports any claim against Andersen based on Household's reaging practices.

B. Plaintiffs' One Claim With Any Nexus To Andersen's Audit Opinions Is Fatally Deficient As A Matter Of Law.

Andersen's audit opinions are even in dispute only because of a disagreement among auditors as to a technical accounting issue that has nothing to do with Plaintiffs' "predatory lending" and reaging allegations. In 2002, Household hired new auditors. Based on the new auditors' recommendations, and contrary to Andersen's views as to the proper accounting, on August 14, 2002, Household announced the adoption of "certain revisions to the accounting treatment of [its] Mastercard/Visa co-branding and affinity credit card relationships, and a credit card marketing agreement with a third party." Cmplt. ¶ 336. The revisions concerned the schedules for amortization of prepaid expenses related to those agreements, and specifically whether new GAAP guidance should be applied retroactively to existing contracts to change the amortization periods or only on a prospective basis. Household restated earnings to reflect the impact of the adjusted items. *Ibid.* In the same press release containing this announcement, Household explained that "[t]hese matters related to accounting for complex co-branded, affinity and credit card marketing agreements, which were discussed with, and approved by, our prior auditors. It clearly is a good-faith difference of opinion." See 8/14/02 Press Release. In its announcement, the company further noted that "[t]he restatement, while disappointing, is small relative to the results we have reported over the period 1993 through 2001." *Ibid.*[3] The restatement had no effect on Household's compounded rate of earnings growth over the affected time period (22% both before and after), nor on Household's cash flow, on-going operations, anticipated results from future operations, or business model. *Ibid.*

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[3] Although the restatement reduced Household's net income by $386 million, that amount was spread out over a 7 ½ year period, for an average reduction of $51.5 million per year. The cumulative charge was inconsequential in relation to Household's income over the affected period of approximately $10 billion and assets of almost $89 billion. Moreover, Household announced that the changes would not have "any significant impact on our future results of operations." *Ibid.*

1. Plaintiffs Will Be Unable To Prove Loss Causation.

When Household announced the restatement, the market shrugged. The restatement's impact was so obviously small, and the adjustment so clearly related to a good-faith disagreement among auditors regarding a technical accounting issue, that the announcement did not cause Household's stock price to drop. In fact, the company's stock actually closed slightly *higher* on the day the restatement was announced. See Cmplt. ¶ 140. The absent of a market fall means that Plaintiffs simply have no claim against Andersen.

Without a market reaction, Plaintiffs would be unable to prevail on their Section 10(b) claim against Andersen, a claim that requires that they prove (among other elements they will be unable to satisfy) that a misrepresentation by Andersen caused their stock to decline in value. As the Supreme Court held recently, the loss causation element is not satisfied by a general claim that the stock price was artificially inflated at the time of plaintiffs' purchase; rather, plaintiffs must allege and prove that the "share price fell significantly after the truth [about the defendant's misrepresentation] became known." See *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627, 1634 (2005). Here, the share price simply did *not* fall when the restatement was announced. The market reaction shows that Plaintiffs suffered no loss based on the restatement of items in the Household financial statements audited by Andersen. Should this litigation continue, Andersen would file a motion to dismiss based on the new Supreme Court authority provided by *Dura Pharmaceuticals.*[4]

Plaintiffs have previously argued that the rise in Household's stock price on the day of the restatement should be disregarded because the stock price was inflated by "Household's continued misrepresentations." In addition to running afoul of the Supreme Court's holding in *Dura*, Plaintiffs' theory simply confirms that plaintiffs have not suffered a loss as a result of misstatements made by *Andersen.*

2. Plaintiffs Will Be Unable To Prove Scienter.

Scienter, the required state of mind for a claim under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, is an "intent to deceive, manipulate, or defraud." *Ernst & Ernst v.*

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[4] In opposing Andersen's pre-*Dura* motion to dismiss, plaintiffs argued that loss causation could be established merely by showing that the undisclosed scheme caused the market price of the company's stock to be inflated at the time of purchase, without any need to show that the stock price declined when the truth was revealed. That argument is no longer available to plaintiffs after *Dura*.

Hochfelder, 425 U.S. 185, 193 n.12 (1976). Recklessness will satisfy the *Hochfelder* standard, but only if it is "so severe that it is *the functional equivalent of intent.*" *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir. 1995) (emphasis added). Recklessness for purposes of § 10(b) is a mental state "far from negligence" and "akin to conscious disregard." *Comshare*, 183 F.3d at 550 & n.7.

The standard for establishing securities fraud is particularly high when the claim is brought against an outside auditor. *Ritsky Family Ltd. P'ship v. Pricewaterhouse*, 1998 WL 774678, at *9 (N.D. Ill. Oct. 21, 1998) ("The overall standard applied to accountants is a heavy one"). To establish scienter for a securities fraud claim against an outside auditor, plaintiffs must show that:

> '[t]he accounting firm['s] practices amounted to *no audit at all*, or to an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.'

Chu v. Sabratek Corp., 100 F. Supp. 2d 815, 823 (N.D. Ill. 2000) (emphasis added). Accord, e.g., *Danis v. USN Communications*, 121 F. Supp. 2d 1183, 1194 (N.D. Ill. 2000).[5]

The rules are no different just because a company has restated its financial statements. As a threshold matter, despite the restatement, Andersen does not agree that the Household financial statements that Andersen audited contained any errors. With all due respect to KPMG, Andersen stands by the original accounting. If the case goes to trial, Andersen will present expert testimony proving that the original accounting was correct. Moreover, because Andersen did not make or agree to the restatement, it is not an admission against Andersen. See *Beck v. Cantor, Fitzgerald & Co.*, 621 F. Supp. 1547, 1566 (N.D. Ill. 1985).

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[5] See also *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 693 (6th Cir. 2004) (the "especially stringent" standard for scienter on the part of an outside auditor "'requires more than a misapplication of accounting principles,'" but rather a mental state that "'approximate[s] an actual intent to aid in the fraud'") (alteration in original); *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 121 (2d Cir. 1982) (plaintiff must show that the auditor's conduct "approximate[s] an actual intent to aid in the fraud being perpetrated by the audited company").

There are compelling policy reasons for strictly applying the scienter pleading requirement to claims against professionals, such as auditors, because "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975). That danger is particularly great with respect to auditors, who are often the most likely deep-pocket target when a company suffers financial difficulties and whose reputations and livelihoods are acutely sensitive to accusations of fraud—as the situation at Andersen shows.

Second, even if there were errors in prior financial statements requiring restatement, that does not mean there was fraud. As the Seventh Circuit has noted, "[r]estatements of earnings are common." *Goldberg v. Household Bank, F.S.B.*, 890 F.2d 965, 967 (7th Cir. 1989). A restatement can result from "'mistakes in the application of accounting principles.'" *In re Interpool, Inc. Sec. Litig.*, 2005 WL 2000237, at *5 (D.N.J. Aug. 17, 2005) (quoting Accounting Principles Board Opinion No. 20, ¶ 13). Because a restatement may arise from mistakes or negligence rather than fraud, a restatement alone does not raise an inference of scienter even on the part of the company, much less an auditor. See, e.g., *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 433 (5th Cir. 2002) (no inference of scienter from restatement where complaint's allegations were consistent with negligence rather than fraud); *SCB Computer Tech. Sec. Litig.*, 149 F. Supp. 2d 334, 353 (W.D. Tenn. 2001) ("Allowing for a strong inference of scienter from restated financial results when the practices leading to the original financial results fail to support a strong inference of scienter would be equivalent to building a house without a foundation."). Such is the case here.

Plaintiffs contend that the amortization rates used by Household for its co-branding and affinity credit card agreements and marketing agreements were improper, and that after hiring a new auditor (KPMG), Household "corrected its amortization schedules for prepaid expenses related to those agreements," recognized expenses immediately (rather than over the life of the contract) for the marketing agreements, and restated previously reported financial results to account for the change. Cmplt. ¶ 135. Significantly, although Plaintiffs contend that KPMG disagreed with Andersen, they offer no facts to suggest that this disagreement was anything other than a good-faith disagreement among accountants concerning a complex accounting issue. In fact, that is all it was.

"[A] difference of professional opinion" as to a matter of "complex professional judgment" in an audit "falls far short of liability for securities fraud." *Monroe v. Hughes*, 860 F. Supp. 733, 739-40 (D. Or. 1991), aff'd, 31 F.3d 772 (9th Cir. 1994). See also *Ziemba v. Cascade Int'l.*, 256 F.3d 1194, 1210 (11th Cir. 2001) (securities fraud not shown by auditor's judgment as to application of accounting principles because "there are no bright lines" and "discretion is necessarily involved").

The restatement arose from good-faith differences of opinion between Andersen and KPMG over complicated accounting issues (which included (a) whether the new guidance provided by EITF Release No. 93-1 should be applied to existing contracts or only on a prospective basis, (b) the highly judgmental issue of whether an action was a modification to an existing agreement, and (c) whether a modification, if any, to an existing agreement was significant enough to warrant application of the new GAAP in EITF No. 93-1, which represented a change from prior acceptable methods and provided new specific guidance where none existed before). Such a technical disagreement is hardly the stuff of fraud.

II. THE PROPOSED SETTLEMENT IS FAIR, REASONABLE AND ADEQUATE GIVEN THE PRACTICAL REALITIES OF ANDERSEN'S CURRENT SITUATION.

Andersen understands that no members of the class have filed objections to the proposed settlement. In addition, requests for exclusion from the class are *de minimis*; Andersen understands that the claims administrator has received only 24 requests representing a total of approximately 3,500 shares in the aggregate. The members of the class, including many sophisticated institutional investors, apparently recognize that a settlement with Andersen now, even for a relatively modest sum and a promise of cooperation, makes more sense than a high-risk gamble on a greater recovery later. The absence of objections by any class members supports the fairness, reasonableness and adequacy of the proposed settlement. *E.g.*, *Hanlon v. Chrysler Corp.*, 150 F.3d 1011, 1027 (9th Cir. 1998); *In re PaineWebber Ltd. Partnerships Litig.*, 171 F.R.D. 104, 126 (S.D.N.Y. 1997), *aff'd*, 117 F.3d 721 (2d Cir. 1997).

Given the facts that Andersen lacks any insurance coverage for this case, and is a defendant in numerous suits demanding billions of dollars in aggregate damages—a number of which are similarly uninsured—and has limited assets available (see Niemann Decl. ¶¶ 3-6), this Court should be loath to second-guess the conclusion reached by Plaintiffs' counsel and the class that the proposed settlement is in their best interests. The sheer number of claims pending against Andersen and the total damages sought raise the specter that absent settlement, there may be no recovery for the class at all (even if the class should somehow manage to prevail on their weak claims against Andersen). See *EEOC v. Hiram Walker & Sons*, 768 F.2d 884, 891 (7th Cir. 1985) (no abuse of discretion in approving settlement for "a small percentage of plaintiffs' asserted loss" "given likelihood that plaintiffs would receive nothing if the case went to trial").

III. THE MEMORANDUM FILED BY THE HOUSEHOLD DEFENDANTS PROVIDES NO REASON FOR THE COURT TO DECLINE TO APPROVE THE SETTLEMENT.

The Household Defendants have filed a curious document in which they state repeatedly that they have no objection to the proposed settlement, and that they have concluded that the settlement is fair, reasonable and adequate[6], but then observe irrelevantly that the class should also settle with them for a comparably low payment. The Household Defendants' memorandum, which is (at best) merely a transparent effort to litigate Household's dispute with the class by disparaging Plaintiffs' claims in connection with this settlement should be stricken and disregarded.[7]

As a threshold matter, the Household Defendants lack standing to be heard on the proposed settlement. "The general rule, of course, is that a non-settling party does not have standing to object to a settlement between other parties." *Agretti v. ANR Freight System, Inc.*, 982 F.2d 242, 246 (7th Cir. 1992). Indeed, the very case that the Household Defendants cite, *Agretti*, plainly holds that a non-settling defendant does not have standing to object to the reasonableness of a settlement. *Ibid.* See Household Def. Memo. at 3. That is exactly what the Household Defendants purport to address and they have no standing to do so.[8]

Nonetheless, the Household Defendant's presentation is based on a misleading, incomplete and inaccurate chart of settlements to which Andersen agreed in the 2001-2005 time

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[6] See Household Def. Memo. at 1 ("the Household Defendants have concluded that the proposed [settlement] amount is not unreasonable"), 3 ("the Household Defendants do not object" to the proposed settlement), 10 (the "Household Defendants do not object to a finding that the proposed settlement is 'fair, reasonable and adequate'").

[7] The Household Defendants' memorandum also contains a number of inaccurate statements. For example, the Household Defendants argue that any settlement involving them should be for a reduced amount because the Andersen settlement supposedly was negotiated based on a five-year class period, and the Court has now reduced the class period to three years pursuant to the Court of Appeals' decision in *Foss v. Bear Stearns Co.*, 394 F.3d 540 (7th Cir. 2005). In fact, as the Household Defendants are aware, Andersen filed a motion to dismiss based on *Foss* on March 7, 2005. That motion was withdrawn, without prejudice to renewal, to allow the parties to participate in the mediation. Thus, Andersen negotiated the proposed settlement based on the expectation that early purchasers in the class period would have their claims denied as required by *Foss*.

[8] A narrow exception allows a non-settling party to be heard where it "can show plain legal prejudice resulting from the settlement." *Agretti*, 982 F.2d at 246. To have standing, the non-settling party must show that the settlement would interfere with the exercise of "that party's legal rights." *Id.* at 247. "Mere allegations of injury in fact or tactical disadvantage as a result of a settlement simply do not rise to the level of plain legal prejudice." *Ibid.* The Household Defendants do not even attempt to meet this standard. Because they do not claim that they would be disadvantaged in any way by approval of the proposed settlement, the Household Defendants lack standing to be heard on this matter.

period. See Household Def. Memo. at 5 n.1 and Appendix A. *First,* the Household Defendants cite Andersen's settlements in the Sunbeam and Boston Chicken cases in April 2001 and February 2002. Those settlements occurred prior to the indictment that devastated Andersen's business, and are plainly of no relevance to the settlement amounts that Andersen could or would agree to under the present circumstances. See *Roquet*, 398 F.3d at 587-88 (public announcement of the indictment on March 14, 2002 "triggered massive client defection" and "the need for mass layoffs"; "[u]p until then, Andersen suffered no marked loss of business"). *Second,* the Household Defendants cite Andersen's settlements in the Enron, Measurement Specialties, Dynegy, WorldCom, Global Crossing and Qwest Communications cases. In each of those cases, Andersen had insurance. In stark contrast, Andersen has no insurance for this case. See Niemann Decl. ¶ 3. Moreover, the examples the Household Defendants cite fail to prove whatever point they might hope to make. In the Dynegy case, for example, the court approved a settlement where Andersen paid $1.05 million, constituting only 0.2% of the $468 million total settlement. See Household Def. Memo. at 5 n.1 and Appendix A. *Third,* the Household Defendants fail to mention a number other Andersen settlements that do not support their assertion that Andersen's situation has no bearing on approval. The Nicor securities litigation in this District is a good example. There, the Nicor defendants paid $38.5 million to settle and Andersen paid only $500,000, a ratio of 1.25%. Neimann Decl. ¶ 6. Among other approved settlements that the Household Defendants fail to mention are: the Enron ERISA class action (July 2005), in which Andersen paid $1.25 million; Sunterra (January 2005), in which Andersen paid $1.4 million; and Intelect Communications (April 2005), in which Andersen paid $1.65 million. Niemann Decl. ¶ 6. Indeed, courts have consistently approved class action settlements in which Andersen has paid less than here. In fact, the proposed settlement here is consistent with the other cases that Andersen has settled in the post-indictment period. See *ibid.*[9] Thus, the facts as to the post-indictment settlements, particularly in cases not covered by insurance, simply confirm the reasonableness of the proposed settlement here. The reasonableness of this proposed settlement is even more apparent given that this settlement would be a partial settlement only,

[9] Indeed, the only cases in the Household Defendants' Appendix A that fall into that category, the I2 Technologies and Charter Communications settlements, confirm the point: in those cases, Andersen paid $2.9 million and $2.25 million, respectively, amounting to only 3.4% and 1.5%, respectively, of the total settlement payments.

and Andersen has offered additional consideration in the form of cooperation with Plaintiffs in their litigation of claims against the non-settling Household Defendants.

The bottom line is that the Household Defendants correctly do not object to the proposed settlement—on the contrary, they agree that it is fair, reasonable and adequate—and they offer no reason for the Court to decline to approve the proposed settlement.

Conclusion

For all of the foregoing reasons, Andersen respectfully submits that the proposed settlement should be approved.

Dated: March 30, 2006

Respectfully submitted,

s/ Stanley J. Parzen

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CERTIFICATE OF SERVICE

I hereby certify that on March 30, 2006, I caused to be served copies of the foregoing Memorandum of Defendant Arthur Andersen, LLP in Support of Proposed Settlement with Plaintiff Class upon the following persons through the CM/ECF system:

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