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

THE CLASS' REPLY BRIEF IN SUPPORT OF OBJECTION TO THE MAGISTRATE'S ORDER REGARDING THE APPLICATION OF THE WORK-PRODUCT DOCTRINE TO AUDIT LETTERS AND RELATED DOCUMENTS

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I. INTRODUCTION

The Class respectfully submits this reply memorandum in response to the Household Defendants' and Arthur Andersen LLP ("Andersen")'s oppositions to the Class' Objection to Magistrate Judge Nolan's July 6, 2006 Order ("Class' Obj."). *See Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, No. 02 C 5893, 2006 U.S. Dist. LEXIS 49319 (N.D. Ill. July 6, 2006) ("Order"). Neither the defendants, nor Andersen provide a compelling reason for the Court to affirm the Magistrate's Order. Rather, testimony obtained from Household International, Inc.("Household" or the "Company")'s own auditor demonstrates that the audit letters and related documents are not work product.[1] Household, like all other public companies, is required to disclose all existing material legal proceedings in its financial statements in Item 3 of its Forms 10-K public filings. Household's outside auditor is required to evaluate Household management's representations regarding legal proceedings in order to ensure that they comply with Generally Accepted Accounting Principles ("GAAP") standards under Statement of Financial Accounting Standards ("SFAS") No. 5 for both the nature of the disclosure as well as the amounts of accruals. *See* Statement on Auditing Standards ("AU") §337, attached hereto as Exhibit 1.[2] Management's representations are provided to the auditor through internal or external legal counsel in the form of audit letters. *Id.* at 3-5; *see also* Flanagan Decl., ¶¶21-27.[3] Indeed, Household's auditor, KPMG LLP ("KPMG"), testified that it could not have given Household an unqualified or "clean" audit opinion without evaluating the litigation claims and assessments then existing at Household. *See* Ex. 2 at 54:38 (KPMG Fed. R. Civ. P. 30(b)(6) Deposition Transcript of Williams S. Long). Even the American Bar Association's Statement of Policy recognizes that audit inquiry letters and the attorney responses are standard procedure in an auditor's review and analysis of a corporation's financial status as well as in the issuance of public financial statements. Ex. 3.

The Complaint alleges that defendants violated GAAP (specifically Financial Accounting Standards ("FAS") No. 5) and Securities and Exchange Commission ("SEC") rules by failing to disclose the level of risk due to litigation from Household's predatory lending practices and the

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1 Audit letters are also referred to as "legal letters" or "lawyer's response to audit inquiry letters."

2 All exhibits are attached hereto unless otherwise noted.

3 "Flanagan Decl." refers to the Declaration of Kirsten L. Flanagan, CPA (Dkt. No. 521).

potential loss contingencies resulting from its illegal predatory lending practices that ultimately resulted in a $525 million pre-tax charge during 3Q02. ¶¶102-106 (paragraph references, unless otherwise indicated are to the Complaint). Defendants have denied these allegations and are relying on their auditors' opinions in their defense. Audit letters and related documents, are thus, highly relevant to this litigation and go to the critical elements of scienter and materiality.

The Magistrate's holding is contrary to established Seventh Circuit case law that the work-product doctrine applies only to those documents where the primary motivating purpose for the creation of the document was to aid in future litigation to protect the audit letters and related documents. *Binks Mfg. Co. v. National Presto Indus., Inc.*, 709 F.2d 1109, 1119 (7th Cir. 1983); *Mattenson v. Baxter Healthcare Corp.*, 438 F.3d 763, 767-68 (7th Cir. 2006), *reh'g denied*, No. 04-4270, 2006 U.S. App. LEXIS 8147 (7th Cir. Mar. 31, 2006). The work-product doctrine was designed to prevent the adversary form obtaining an undue advantage in the litigation. Here, the Class is not seeking the mental impressions or thoughts of Household's attorneys. And, neither does the Class gain any advantage in the litigation from discovery of the audit letters and related documents. Rather, the Class seeks to elicit what information was disclosed to Household's auditors regarding relevant predatory lending litigation in the course of Household's audit. Stripped of all the rhetoric, the practical impact of the Magistrate's Order is to allow defendants to rely on conclusions reached by its auditors while at the same time depriving the Class of critical information related to its claims.

Relying on the same erroneous legal premise, the Magistrate also erred in finding the litigation database and litigation reserves to be protected under work-product despite the fact that defendants had not carried their burden of demonstrating that such protection applied. For all the reasons outlined in the Class' Objection, the Flanagan Declaration, this reply brief, and accompanying attachments, the Magistrate's Order should be overruled.[4]

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[4] A magistrate judge's legal conclusions are subject to de novo review, while findings of fact are subject to clear error. *McFarlane v. Life Ins. Co.*, 999 F.2d 266, 267 (7th Cir. 1993); *Todd v. Corporate Life Ins. Co.*, 945 F.2d 204, 207 (7th Cir. 1991).

II. ARGUMENT

A. Audit Letters Are Prepared Solely for the Purpose of Obtaining an Unqualified Audit Opinion from Household's Outside Auditors

Consistent with the Flanagan Declaration, the testimony of Household's outside auditor KPMG unequivocally demonstrates that audit letters are prepared "because of" an audit, and not "because of" or to aid in pending or threatened litigation. Thus, work product does not apply. KPMG's corporate witness testified that Household's outside auditor is required to have an understanding of the legal matters (including loss contingencies arising from litigation, claims, and assessments) as part of the audit process. Ex. 2 at 50:19-51:2; *see also* Flanagan Decl., ¶¶15-17, 21-34. KPMG testified that as the auditor it "received . . . legal letters as part of our audit process." Ex. 2 at 50:11-13; 51:17-24; Flanagan Decl., ¶¶21-25, 35-39. Household's auditor testified that its evaluation of litigation claims and assessments outlined in audit letters was relevant to its analysis of FAS 5 contingencies, which address both the actual accruals for loss contingencies as well as the disclosures made to the public regarding such contingencies in Household's financial statements. Ex. 2 at 53:2-9. KPMG further testified that it could ***not*** have provided Household with an unqualified opinion on the financial statements it was auditing without evaluating the litigation claims and assessments then existing at Household, which KPMG stated it obtained through the audit or legal letters. *Id*. at 54:3-8.

Recognizing that audit inquiries and lawyer's responses to such inquiries are part of the routine audit process, the American Bar Association ("ABA") has issued a Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information under AU §337 ("SOP"), which lays out the "standard" and the "scope" recommended by the ABA for the lawyer's responses to such letters. *See* Ex. 3. The ABA SOP is "designed to recognize the obligation of the auditor to complete the procedures considered necessary to satisfy himself as to the fair presentation of the company's financial condition and results, in order to render a report which includes an opinion not qualified because of a limitation on the scope of the audit." *Id.* at 8. The ABA SOP further defines the scope of the audit letter as follows: The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5). *Id.* at 2. Not surprisingly, "[l]awyers' responses to auditors' inquiries have come to be known as 'audit response letters' or 'FASB 5 letters.'" Douglas R. Richmond, *The Attorney-Client Privilege and Associated Confidentiality Concerns in the Post-Enron Era,* 110 Penn St. L. Rev. 381, 401 (2005).

Significantly, the ABA SOP explicitly provides that lawyer's responses "shall be ***solely for the auditor's information in connection with his audit of the financial condition of the client*** and is not to be quoted in whole or in part or otherwise referred to in any financial statements of the client or related documents, nor is it to be filed with any governmental agency or other person, without the lawyer's prior written consent. Ex. 3 at 5.[5] Notwithstanding such limitation, ***the response can properly be furnished to others in compliance with court process.***" *Id*. The ABA SOP, although concerned with the attorney-client privilege, does not reference the work-product doctrine. The reason is simple – a lawyer's responses to auditors are not entitled to work-product protection. Thus, even the ABA position seems to be that audit letters are discoverable.[6]

Defendants concede that the Magistrate ignored the Flanagan Declaration submitted by the Class in support of its position that audit letters are prepared "because of" an audit. Defs' Mem. at 7.[7] Defendants claim, however, that because these letters would not exist in the absence of any pending or threatened litigation, the Flanagan Declaration is irrelevant. *Id*. As detailed above, the audit letters and related documents were not drafted to assist Household's counsel to prepare for litigation. Indeed, "the mere existence of that litigation alone or counsel's request that the documents be prepared will not convert business documents into work product." *Bairnco Corp. Sec. Litig. v. Keene Corp.*, 148 F.R.D. 91, 103 (S.D.N.Y. 1993) (citing *Simon v. G.D. Searle & Co.*, 816 F.2d 397, 401 (8th Cir. 1987) (risk management documents relating to pending product liability suits used in business planning are not work product); *United States v. Gulf Oil Corp*., 760 F.2d 292, 297 (Temp. Emer. Ct. App. 1985) (documents generated for business purpose of creating financial statements which would satisfy requirements of federal securities laws not protected by work

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[5] All emphasis is added and all citations and internal quotations are omitted unless otherwise noted.

[6] Audit inquiry letters and the attorney responses are standard procedure in an auditor's review and analysis of a corporation's financial status. Melissa D. Shalit, *Audit Inquiry Letter And Discovery: Protection Based on Compulsion*, 15 Cardozo L. Rev. 1263, 1279 (1994). Audit inquiry letters and the attorney responses result from the "regular internal operation" of the client-corporation's business, not from the need to prepare for trial. *Id*. at 1280. The SEC mandates that the accountant include in the corporation's financial statements any potential liabilities that may affect a corporation's financial status. *Id*. The only way he can comply with respect to potential litigation, claims, and demands is to request information from the corporation's attorney. The attorney responds in order for the client to file properly its securities registration, not "in anticipation of litigation." *Id*.

[7] "Defs' Mem." refers to Defendants' Memorandum in Opposition to Plaintiffs' Objections to the Magistrate Judge's July 6, 2006 Order.

product privilege); *Medinol, Ltd. v. Boston Sci. Corp.*, 214 F.R.D. 113, 115 (S.D.N.Y. 2002) ("a company must open its books and records to an independent auditor for review [and] [t]he independent auditor is required to express an opinion, based on a review according to generally accepted auditing standards").[8]

Further, in defense of this action, defendants here will rely on Household's auditor's review of the audit letters and the auditors' conclusions that Household's accruals and disclosures relating to SFAS 5 criteria during the Class Period were adequate. *See* Ex. 2 at 193:8-21. Indeed, KPMG testified that it relied on the audit or legal letters and various other detailed workpapers in arriving at its conclusion that Household's disclosures as well as accruals for loss contingencies during the Class Period were adequate. *Id*. at 222:42-223:8. Thus, the very nature of the Class' claims and defendants' plausible defenses place at issue the content of the documents that defendants seek to withhold from the Class. Since the beliefs held and opinions expressed by Household's counsel concerning the status and impact of litigation related to the Company's predatory lending practices, as well as pertinent information defendants may have concealed, will necessarily be in question. Withholding this information from the Class, permits the Household Defendants to use privilege at once as both a sword and a shield.

The Class' Complaint specifically alleges that defendants failed to disclose the risk due to litigation from Household's predatory lending practices, or the impact of such practices on Household's bottom line to investors. ¶¶104-106. Not surprisingly, there is no source for the disclosures Household made to its auditors regarding loss contingencies related to litigation claims and assessments, other than the audit letters and the auditors' internal memos.

For instance, in *Bairnco*, the court found that the opinions rendered by Keene Corporation's counsel concerning the condition of asbestos-related litigation, as well as the underlying facts and information passed to Keene from counsel, were clearly relevant to the central issue of scienter. 148 F.R.D. at 100. The court found there was no work-product protection because to "permit Keene to

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[8] *See also United States v. El Paso Co.*, 682 F.2d 530, 544 (5th Cir. 1982) (finding that where a document was "[w]ritten ultimately to comply with SEC regulations," it "carrie[d] much more the aura of daily business than it does of courtroom combat"); *Independent Petrochemical Corp. v. Aetna Cas. & Sur. Co.*, 117 F.R.D. 292, 298 (D.D.C. 1987) (declining to extend work product protection to audit letters prepared by an attorney because they were prepared to assist accounting firm "in the performance of regular accounting work done by such accounting firms"); *McEwen v. Digitran Sys., Inc.*, 155 F.R.D. 678, 684 (D. Utah 1994) (concluding that documents were not protected by the work-product privilege because the "primary motivating purpose" behind their creation was the re-issuance of defendant's financial statements).

offer the fact of counsel's conclusions where such conclusions serve Keene's purposes without permitting plaintiffs access to all the communications between counsel and Keene would prejudice plaintiffs in the prosecution of their action." *Id*. Under these circumstances, it is a patently unfair result to allow the Household defendants here to rely on its auditor's opinion regarding the adequacy of the Company's SFAS No. 5 disclosures and accruals, yet prohibit the Class from access to the workpapers that formed the basis of this audit opinion. *See United States v. Bilzerian*, 926 F.2d 1285, 1292-93 (2d Cir. 1991) (a defendant may not use the privilege to prejudice his opponent's case or to disclose some selected communications for self-serving purposes).

Household cannot hide behind the protection of work-product to conceal the audit letters and related documents from the Class. The Magistrate committed clear error in disregarding the Flanagan Declaration and other evidence and by overlooking the primary purpose for the creation of the audit letters and related documents, *i.e.*, the audit of Household's financial statements, or the gravaman of the Class' securities fraud complaint.

B. The Magistrate's Misunderstanding of the Audit Letters and the Purpose for Their Creation Resulted in the Finding of Work Product that Was Contrary to Seventh Circuit Law

1. Seventh Circuit Law Only Protects Documents as Work Product that were Created Primarily to Aid in Future Litigation

The law in this Circuit is that a document is accorded work-product protection where the primary motivation behind the creation of the document was to assist in determining whether to pursue litigation and to aid in possible litigation. *Binks*, 709 F.2d at 1119; *Mattenson*, 438 F.3d at 767-68 (finding notes from meeting in which attorney was anticipating and preparing for litigation against Mattenson were work product). The *Binks* court specifically found that documents and investigative reports created in the ordinary course of business were not "'prepared . . . because of the prospect of litigation.'" 709 F.2d at 1120; *see also SmithKline Beecham Corp. v. Pentech Pharms., Inc.*, Case No. 00 C 2855, 2001 U.S. Dist. LEXIS 18281, at **7-8 (N.D. Ill. Nov. 5, 2001) ("documents created in the ordinary course of business [] cannot be withheld as work product").

Thus, in the Seventh Circuit, only where the primary motivating purpose for creating the document is to aid in litigation is it deemed prepared "because of" litigation, and only then is it protected by the work-product doctrine. *Binks*, 709 F.2d at 1119-20. Moreover, courts have found that "[t]o the extent the information in these letters must be disclosed in the public financial statements of the company being audited, it is not entitled to work product protection even under the

broader 'because of litigation' definition of the privilege." *In re Raytheon Sec. Litig.*, 218 F.R.D. 354, 359 (D. Mass. 2003); *see also Gulf Oil*, 760 F.2d at 297; *Medinol*, 214 F.R.D. at 115; *supra* n.6. The Magistrate erred in failing to follow this precedent, including her own ruling in *SmithKline*. Order at **12-14.

The Seventh Circuit's long-standing position on the work-product doctrine is consistent with the Advisory Committee Notes to the 1970 Amendment to Fed. R. Civ. P. 26(b)(3), which specifically state: "Materials assembled in the ordinary course of business, or pursuant to public requirements unrelated to litigation, or for other nonlitigation purposes are not under the qualified immunity provided by this subdivision." Fed. R. Civ. P. 26(b)(3) Advisory Committee Notes. Further, the Seventh Circuit's interpretation of the work-product doctrine is consistent with the Supreme Court's exhortation that evidentiary privileges, because they impede the search for truth, must be narrowly construed. *See Pierce County v. Guillen*, 537 U.S. 129, 144-45 (2003); *University of Pa. v. EEOC*, 493 U.S. 182, 189 (1990). The Seventh Circuit has also declared that it will "not read the 'in anticipation of litigation' requirement broadly," *In re Special September 1978 Grand Jury (II)*, 640 F.2d 49, 65 (7th Cir. 1980), and the decision on the facts in *Binks* confirms that this Circuit looks for a very substantial and specific threat of litigation. *Harper v. Auto-Owners Ins. Co.*, 138 F.R.D. 655, 661 (S.D. Ind. 1991).

Although defendants acknowledge that the analysis of the application of work product includes an evaluation of "the primary motivating purpose behind the creation of a document or investigative report," they claim this analysis is only relevant to the determination of whether the prospect of litigation is remote or more tangible. Defs' Mem. at 6. Defendants' attempts at creating a distinction where none exists are misplaced – they cannot cite to *Binks*, because *Binks* does not make this distinction. The Magistrate's Order must therefore be overruled for failing to follow Seventh Circuit law.

2. The Magistrate's Order that Disputed Documents Need Not Have Been Created for Use Against the Opposing Party in the Litigation at Issue Is Clearly Erroneous Because Audit Letters Were Not Created for Any Litigation, Let Alone This Securities Fraud Litigation

The Class' Objection details why the Magistrate's Order is clearly erroneous for failing to follow Seventh Circuit precedent outlined in *Binks*. Class' Obj. at 9-10. *Binks* clearly mandates that work-product protection extends only to some "articulable claim likely to lead to litigation" which "must pertain to this particular opposing party, not the world in general." *SmithKline Beecham*,

2001 U.S. Dist. LEXIS 18281, at *9; *see also Mattenson*, 438 F.3d at 767-68 ("the work-product doctrine shields materials that are ***prepared in anticipation of litigation from the opposing party***"). In *SmithKline Beecham*, Magistrate Judge Nolan examined two sets of documents over which defendants asserted work-product protection and found that only documents created when "litigation with this particular opposing party was anticipated" were protected while the other set created prior to that time were not. 2001 U.S. Dist. LEXIS 18281, at **10-15. Thus, the Magistrate's decision in this case contradicts well-established law, including her own precedent.

Since the audit letters and related documents at issue here were never prepared in anticipation of litigation against the Class and in fact, were not prepared for litigation at all, defendants' argument that the work-product privilege lasts infinitely, is a red herring. *See* Defs. Mem. at 9-12. The cases cited by defendants are based on (1) the existence of a prior litigation, and (2) a finding that the documents at issue in the prior litigation were covered by the work-product privilege. Defendants' contentions of the infinite duration of the work-product privilege (if one ever existed) and lengthy citations in support thereof, are simply inapplicable here. In each of the cases cited by defendants, there was no dispute as to whether the materials at issue constituted work product in the prior litigation. Here, the documents were not prepared in anticipation of litigation and whether they are work product is heavily disputed.[9]

Similarly, defendants' reliance on cases that extended work-product protection to audit letters where they were being sought in the litigation at issue, is misguided. *See* Defs' Mem. at 7 (citing *Tronitech, Inc. v. NCR Corp.*, 108 F.R.D. 655 (S.D. Ind. 1985)). In *Tronitech*, a company's accounting firm asked the company's lawyer "to prepare a legal opinion concerning the financial implications of ***this [Tronitech's] law suit***." *Id*. The court found that the opinion was a document "prepared because of ***the litigation***, and it is comprised of the sum total of the attorney's conclusions

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[9] *See Hobley v. Burge*, 433 F.3d 946, 947, 948 (7th Cir. 2006) (handwritten litigation notes by City of Chicago's ("City") attorneys and attorney-prepared outlines in connection with their representation of the City in a prior, related employment termination matter sought by plaintiffs in connection with a later 42 U.S.C. §1983 action against the City were found to be work product because of the ***near identity of the issues in both cases***); *FTC v. Grolier, Inc.*, 462 U.S. 19, 21-28 (1983) (FOIA request for FTC documents generated by an investigation relating to a prior lawsuit against Grolier, Inc.'s subsidiary, which were classified as "work product" – the Court never reached the question of whether work product is immune from production in a subsequent litigation because the documents at issue were protected on an independent statutory basis); *In re Grand Jury Proceedings*, 43 F.3d 966, 972 (5th Cir. 1994) (subsequent grand jury investigation sought work product prepared for prior litigation involving the seizure of certain assets). Thus, other cases cited by defendants are similarly inapposite.

and legal theories concerning ***that litigation***." *Id*. at 656. This holding is consistent with the Seventh Circuit reasoning that only those documents prepared for litigation against the opponent seeking production implicate the interest of preventing an opponent from gaining insight into the strategy of the opposing party. *See Mattenson*, 438 F.3d at 767-68. Here, the Class is not seeking audit letters discussing this securities fraud litigation, but rather audit letters that were created during the Class Period that discuss (or conceal) the impact of Household.

3. The Seventh Circuit's Pronouncement on Dual-Purpose Documents is Unequivocal – They Are Not Protected by the Work-Product Doctrine

The audit letters and related documents are clearly business documents prepared for the purpose of an audit. *See supra*, §II.A. Even if they could somehow be classified as prepared to aid in possible future litigation – which they obviously were not – the Magistrate erred in attempting to carve out an exception to the well-established Seventh Circuit law that dual-purpose documents are not protected as work product. *See* Order at **15-16; *see also United States v. Frederick*, 182 F.3d 496, 501-02 (7th Cir. 1999) (finding that the documents at issue were not privileged as work product, stating simply "[m]ost are ***dual-purpose documents, about which no more may be said***"); *see also Harper*, 138 F.R.D. at 661 (S.D. Ind. 1991) ("Documents prepared for concurrent purposes, therefore, should not be classified as work product."); *Pacamor Bearings v. Minebea Co.*, 918 F. Supp. 491, 513 (D.N.H. 1996) (exclusion from work product protection of materials assembled "pursuant to public requirements unrelated to litigation" applies "even if the party is aware that the document may also be useful in the event of litigation").

The Magistrate and the defendants assert that the audit letters and related documents at issue here are distinguishable from the documents at issue in *Frederick* and *Harper* (the cases rejected by the Magistrate in the Order) because without pending or threatened litigation, these documents would not exist. Order at **16-18. First, as clarified by the ABA SOP, the audit letters are to be used "solely" by the auditor in connection with the audit of financial statements. Ex. 3 at 5. Second, the head of Household's Audit Committee, Louis Levy, testified that Household's General Counsel presented a report of pending litigation to the Board for the purpose of determining whether the financial statements were accurate. Ex. 4 at 23:22-24:16. Accordingly, the Magistrate's conclusions regarding the audit letters are clearly erroneous.

Defendants cite to the case of *Special September* to support their assertion that dual purpose documents are covered by work product. 640 F.2d at 61; Defs' Mem. at 8-9. In *Special September*,

the Seventh Circuit found there that the sequence of events clearly demonstrated that "the law firm knew ***before*** it began to prepare the reports that the Grand Jury as well as the Illinois State Board of Elections wanted information concerning political contributions by the Association." 640 F.2d at 61-62. Hence, the Court concluded that the subpoenaed materials were indeed prepared in anticipation of litigation.

Similarly, in *In re Grand Jury Subpoena*, 357 F.3d 900 (9th Cir. 2003), the Environmental Protection Agency ("EPA") informed Ponderosa Paint Manufacturing, Inc. ("Ponderosa") that it was under investigation for violating federal waste management laws in May 2000. *Id*. at 904-905. Ponderosa hired attorney John McCreedy to advise and defend it in anticipated civil and criminal litigation with the government. *Id*. McCreedy, on behalf of Ponderosa, retained Mark Torf, an environmental consultant, to assist him in preparing a legal defense for Ponderosa and as an environmental consultant on Ponderosa's cleanup efforts at the sites that aroused the EPA's suspicions. *Id*. About two years later, a grand jury investigating Ponderosa issued a subpoena to consultant Torf for all records relating to his work regarding the disposal of waste material from Ponderosa. *Id*. Here, the Ninth Circuit, specifically noting that it was ***not*** addressing the question whether protection under the work-product doctrine may be extended to "dual-purpose" documents, found that the documents were protected because Torf created the withheld documents at the direction of McCreedy, an attorney who was hired to defend Ponderosa in impending litigation with the government. *Id*.

The crucial factor in both *Special September* and *Grand Jury* is that defendants only began their investigation ***after*** learning that the federal government was investigating it for criminal wrongdoing; a circumstance virtually necessitating legal representation. The audit letters and related documents at issue here were not prepared upon learning of an ongoing investigation, but rather as part of the ongoing audit process undertaken in connection with Household's mandatory public reporting obligations. Thus, neither *Special September*, nor *Grand Jury* supports defendants' position.

C. The Magistrate Committed Clear Error in Finding the Litigation Database to Be Covered by Work-Product Despite Glaring Contradictions in Defendants' Affidavits

The Magistrate based her finding that the litigation database was covered by work-product because the database had "***never been disclosed*** to Household's outside auditors or any other third

party." Order at **24-25 (citing Leopold Aff. (Dkt. No. 529), ¶¶4-5). There is significant evidence in the record that this finding is clearly erroneous.

The documents themselves unequivocally demonstrate that Household's outside auditor did ***in fact review*** the legal database. Andersen audit employee Danielle Valkner in her internal memo validating Andersen's conclusions regarding the adequacy of the litigation reserves as well as the disclosures confirms that she "review[ed] a sample of cases from ***Household's legal database*** to ensure completeness" of Household management and counsel's representations. Mehdi Decl., (Dkt. No. 524) Ex. 1 at AA 059988-89; Ex. 4 at AA16216; Ex. 10 at AA 058177.[10] The Magistrate erred in finding that the language above "does not establish that Andersen actually viewed the database itself." Order at *26.

Importantly, defendants offer no explanation for the inconsistencies of the affidavits of Deputy General Counsel Mark Leopold. First, Leopold swore that the database was "***never disclosed***" to Household's outside auditors. Leopold Affidavit, ¶¶4-5. Faced with evidence to the contrary, Leopold and defendants changed their tune (and sworn testimony). Leopold now states that "the litigation data ***is not routinely shared*** with Household's outside auditors." Leopold Supp. Aff. (Dkt. No. 564), ¶2. Their bluff having failed, defendants now argue that even if the plaintiffs can demonstrate that the litigation database as disclosed to Household's auditors, there was no waiver unless "disclosure is made in a way that substantially increases the opportunity for potential adversaries to obtain the information." Defs' Mem. at 13-14. Their new arguments must fail.

First, the Magistrate based her holding on the specific finding that the database was "never disclosed to Household's outside auditor." Order at **24-25. Second, because the auditor's review of the database was for the business purpose of performing an audit for a public reporting purpose, rather than for purposes of enabling the accountants to assist the attorneys in rendering legal services, work product simply does not apply. *See* §II.A. *supra*. If it is clear that the "information contained in the document was intended to be disseminated to those outside the cloister of confidentiality, then the privilege is waived." *Gutter v. E.I. DuPont de Nemours & Co.*, Case No.: 95-2152-CIV-Gold, 1998 U.S. Dist. LEXIS 23207, at *9 (S.D. Fla. May 15, 1998).

The other cases cited by defendants are distinguishable and do not support their lack of waiver arguments. For example, in *Southern Scrap Material Co. v. Fleming*, Civil Action No. 01-

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[10] These documents and the underlying briefing has already been provided to the Court.

2554, 2003 U.S. Dist. LEXIS 10815, at **36-37 (E.D. La. June 18, 2003), in finding that work-product protection applied, the Court found significant that (1) Southern Scrap Material Company was a closely held corporation and hence, audit letters were not for the purpose of reporting to the public; and (2) the lawsuits in the audit letters were completely irrelevant to the underlying litigation. *See also Gutter*, 1998 U.S. Dist. LEXIS 23207, at **14-15 (S.D. Fla. May 18, 1998) (finding that legal opinion letters receive no work-product protection because the majority did not contain attorneys' mental impressions, opinions, or legal strategy; reports of unrelated litigations redacted); *Gramm v. Horsehead Indus., Inc.*, No. 87 Civ. 5122 (MJL), 1990 U.S. Dist. LEXIS 773 (S.D.N.Y. Jan. 25, 1990) (attorney memorandum and notes prepared in connection with settlement discussions and anticipated litigation with the current adversary – waiver found as to the notes).

Moreover, contrary to the Magistrate's finding, there is waiver here. When auditors are conducting an audit of a public company, the auditor's interests are aligned with the company's shareholders and creditors, rather than with the company. *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984). In *Arthur Young*, the Supreme Court described the auditor's role as follows:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a ***public*** responsibility transcending any employment relationship with the client. ***The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public***. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. . . .

Id.; (first emphasis in original); *see also* Roberta S. Karmel, *A New Watchdog for Public Accountants*, 228 N.Y. Law J. No. 31 at 3 (Aug. 15, 2002) ("Good auditing requires adversarial tension between the auditor and the client."). Disclosure of work product to a third party that is aligned with the party's adversary waives any privilege that might otherwise have existed. *See Trepanier v. Chamness*, No. 00 C 2393, 2005 U.S. Dist. LEXIS 23293, at **7-8 (N.D. Ill. Oct. 12, 2005).

Further, courts distinguish between documents disclosed to auditors in the course of an audit (*e.g.*, sharing information regarding litigation in audit letters required by GAAP, or information contained in the HAL litigation database or relating to reserves) as opposed to those disclosed to an accountant acting as a consultant. *See Medinol*, 214 F.R.D. at 115. The *Medinol* court recognized that "there is a difference between disclosure to accountants who have been retained by a lawyer to understand technical aspects of a case and whose interests are therefore allied with the client, and

outside auditors who, in order to be effective, must have interests that are independent of and not always aligned with those of the company." *Id*. at 114. In that case, Ernst & Young LLP reviewed meeting minutes of the Special Litigation Committee as part of Ernst & Young's role as an auditor, the court found that the disclosure "did not serve any litigation interest, either [the company's] or that of Ernst & Young, or any other policy underlying the work product doctrine." *Id*. at 116. Thus, disclosure of materials to accountants for audit purposes waived work-product protection.

Accordingly, the Magistrate Order with respect to Request No. 17 for the production of data fields in the litigation database that relate to class actions or suits by a government agency for violations of consumer protection laws or regulations during the Class Period should be overruled.

D. The Magistrate's Holding that the Amount and Establishment of Litigation Reserves Necessarily Entails Attorneys' Evaluation Is Neither Supported by Law, Nor by the Facts of This Case

The Class demonstrated in its objection why the Magistrate erred in holding litigation reserves were entitled to work-product protection. Class' Obj. at 13-15. Household was required under FAS 5 to disclose pending or threatened litigation, and record and disclose loss contingencies (or reserves) relating to such litigation in a manner that investors could understand the Company's potential liabilities, so its financial statements were not misleading. *Id*. at 2 (citing Flanagan Decl., ¶16). Disclosures relating to the adequacy of Household's disclosures regarding FAS 5 loss contingencies are central to this litigation. The Complaint alleges that defendants violated GAAP (specifically FAS 5) by failing to disclose the potential loss contingencies resulting from the Company's illegal predatory lending practices that ultimately resulted in a $525 million charge. ¶¶102-106. Significantly, defendants have failed to demonstrate that they have met their burden of showing that the amount and establishment of reserves is covered by work product. It is axiomatic that the burden is on a party claiming the protection of a privilege to establish those facts that are essential elements of the privileged relationship. *Von Bulow v. Von Bulow*, 811 F.2d 136, 144 (2d Cir. 1987).

For example, in *In re Pfizer Inc. Sec. Litig.*, 90 Civ. 1260 (SS), 1994 U.S. Dist. LEXIS 7454 (S.D.N.Y. June 6, 1994) (a case cited favorably by defendants), the court found documents related to reserves "focus on a business issue, namely how much money Pfizer must hold in reserve consistent with generally accepted accounting principles and SEC reporting requirements." *Id*. at **4-5. The court concluded that because "the primary motivational purpose" behind the creation of the reserve documents was a business and not a legal one, they do not receive work-product protection. *Id.* The

court found that the "documents made broad projections and analyses regarding the extent of Pfizer's financial exposure" and "tend to be actuarial in nature, based on statistical averages." *Id*. at *4. Similarly, in *National Union Fire Ins. Co. v. Continental Illinois Group*, No. 85 C 7080, 1988 U.S. Dist. LEXIS 7826 (N.D. Ill. July 21, 1988), the court granted plaintiff's motion to compel information related to litigation reserves because "it [was] not clear . . . the setting of the reserve was identical with the thought processes of counsel." *Id*. at **5-6.

Further, during the deposition of Household's outside auditor, KPMG testified that the evaluation of litigation claims and assessments (as defined by AU §337) was relevant to KPMG's analysis of FAS 5 contingencies. Ex. 2 at 53:2-5. FAS 5 addresses both the accruals for loss contingencies as well as disclosures. *Id*. at 53:6-9. Household's Assistant Controller, Cliff Mizialko testified that the Controller Steve McDonald was responsible at Household for establishing the required litigation accrual in accordance with FAS 5 during the Class Period. Ex. 5 at 181:24-182:13. The Legal Department only ensured that the decision made by the Controller was adequate, however, the decision was made by the Controller. *Id.* at 182:14-20. Accordingly, Household Defendants' interrogatory response that no attorneys were involved in the determination of the accounting treatment to address litigation risk is significant.

The *Pfizer* court refused to extend work-product protection to aggregate reserve amounts and the methodology for arriving at such amounts based on the rationale that "'[t]he purpose of the work product doctrine – that of preventing discovery of a lawyer's mental impressions – is not violated by allowing discovery of documents that incorporate a lawyer's thoughts in, at best, such an indirect and diluted manner.'" *Pfizer*, 1994 U.S. Dist. LEXIS 7454 at **5-6 (quoting *Simon*, 816 F.2d at 402).

Because the Magistrate misapplied the law, failed to analyze the specific context of this case and failed to demand a showing from defendants that litigation reserves were indeed work product, the Magistrate's July 6 Order regarding Request No. 18 should be overruled.

III. CONCLUSION

For all the foregoing reasons, as well as the arguments outlined in the Class' opening brief, supporting exhibits and declarations, as well as any oral argument parties are allowed to present, the Class respectfully submits that the Magistrate's July 6 Order regarding the application of the work-product doctrine to audit letters and related documents prepared in the ordinary course of an audit should be overruled. The Class should be permitted discovery of such materials, including the litigation database and information relating to litigation reserves. Alternatively, if the Court affirms

the Magistrate's ruling that these documents are covered by the work-product doctrine, then the Household defendants must be barred from seeking to rely on or use the audit opinions at summary judgment or trial.

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Respectfully submitted,

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