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 HOUSEHOLD DEFENDANTS' RESPONSE TO PLAINTIFFS' STATUS REPORT ON STATE AGENCY ISSUES

The Household Defendants respectfully submit this Response in order to correct certain inaccuracies in "The Class' Status Report" dated September 12, 2006 ("Pl. Rep.") and to address Plaintiffs' generalities about their supposed need for cumulative discovery in aid of their amorphous "predatory lending" theory of securities fraud. As for Plaintiffs' predictable attempt to blame Defendants for the fact that some states have forbidden the Company from disclosing supervisory records, Defendants respectfully refer the Court to Defendants' August 21, 2006 Memorandum of Law in Opposition to Plaintiffs' Motion Regarding State Agency Documents for an accurate account of the background of this dispute.

FACTUAL UPDATE

A. The Nature of the Contested Documents

While searching for potentially responsive material in advance of the deposition of former Household employee Robin Allcock, defense counsel located a relatively small number of documents that appeared to be restricted from disclosure by applicable state regulations.[1] These documents primarily took the form of supervisory reports and internal documents or correspondence that disclosed the substance of state agencies' remarks or recommendations regarding the operations of particular branch offices. (Branch offices, which are not banks, are subject to state licensing and/or oversight rather than regulation by federal bank regulators.) Although Plaintiffs refer to such materials as "findings", in fact the documents reflect the normal give-and-take between a regulator and its subject, as opposed to formal findings of fact after an adjudicative proceeding.

As set forth below, several states did not object to Defendants' production of such documents, and Defendants have already produced them, subject to and without waiving their objections as to lack of relevance. A small number of states forbade Defendants from producing documents revealing their deliberative processes, and instructed Defendants to recall

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[1] Plaintiffs' assertion that Defendants had not previously searched for and produced documents from Ms. Allcock's files is incorrect. It was only when counsel interviewed Ms. Allcock in advance of her deposition that they learned about, and promptly collected and reviewed, additional documents from Ms. Allcock's files. Needless to say, Defendants' diligent, continuing efforts to identify additional sources of documents are the antithesis of the dereliction Plaintiffs attempt to depict.

inadvertently produced copies of such documents. In all, Defendants have had to withhold, redact or request the return of only about 450 documents pursuant to these instructions. Plaintiffs' assertion that Defendants have invoked a privilege in their own right as to these documents is mistaken. Rather, the Company is understandably reluctant to defy the instructions of agencies that license and/or supervise its operations, particularly as some states have threatened criminal penalties for unauthorized disclosure of confidential supervisory material.[2]

The documents at issue must be distinguished from the fruits of Plaintiffs' Freedom of Information Act requests to each of ten states in and around January through May 2004, which yielded authorized productions, directly from the states, of customer complaints and other communications with state agencies about Household's consumer lending practices.[3]

B. States' Reponses to Defendants' Requests for Guidance as to Supervisory Material in Ms. Allcock's Files

As previously reported, Defendants timely sought guidance from relevant state agencies as to the proper disposition of confidential state material collected from Ms. Allcock's files. In the meantime, Defendants proceeded to produce over 2,200 responsive documents from the same files, generally relating to Ms. Allcock's responsibilities when she was Vice President

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2 *See, e.g.*, Letter of John P. Hudock, Arizona Department of Financial Institutions to Patricia Farren, attached as Exhibit E to Plaintiffs' Status Report ("Any such disclosure, whether inadvertent or not, is contrary to Arizona law and may be cited as a violation against your clients in the future"); Letter of Michael J. Mach, Wisconsin Department of Financial Institutions to Patricia Farren, attached as Exhibit E to Plaintiffs' Status Report ("Please note that there are criminal provisions for violating Section 220.06. Penalties may include both fines and imprisonment . . . . These orders may include forfeitures of up to $10,000 for each violation and $1,000 for each day that the violation continues."); Letter of D. B. Griffin, III, Hawaii Division of Financial Institutions to Patricia Farren, attached as Exhibit E to Plaintiffs' Status Report ("[I]t is illegal for your client(s) to furnish parties in this litigation with any of the information that would be deemed confidential pursuant to this statute. In fact, providing confidential documents to Plaintiffs in this matter, whether or not inadvertently, subjects your client(s) to penalties, including an administrative fine.").

3 Plaintiffs have refused to disclose all of their follow-up communications with states regarding the disposition of their FOIA requests. For that reason, Defendants do not know the extent (if any) to which Plaintiffs have previously debated the same or similar confidentiality issues with any state agency.

of Operations Support in Household's Consumer Lending business unit.[4] To date, our letters have yielded answers from 25 of the 27 state agencies at issue. We notified Plaintiffs immediately upon receipt of each response, and took the action dictated by each response, as set forth below. Because Plaintiffs' characterization of the states' responses does not always track the plain meaning of relevant correspondence, we provide the following summary — the bottom line of which is that agencies in **eleven** of the questioned states have given us leave to produce supervisory reports and related documents, in some cases subject to compliance with or modification of the Protective Order; **fourteen** agencies have instructed us to withhold such documents and to try to retrieve any copies inadvertently produced in Defendants' vast document production (although some of these agencies indicated they may be open to persuasion); and **two** agencies have not yet replied. The details of the state agency responses are as follows:

- State agencies in **Florida, Kentucky, Maryland, Michigan, Missouri, Montana, New Jersey, Pennsylvania, Texas,** and **Virginia** have given Defendants permission to produce documents that comprise or reflect their supervisory activities. Defendants have produced all such material, pursuant to a representation by Plaintiffs' counsel that they will stipulate to application of the Protective Order where the states so request.

- Although Plaintiffs assert that **Nebraska** "has no issue" with the production of its documents, the relevant agency notified Defendants that supervisory documents can be produced only if the Court orders a modification to the Protective Order to encompass such documents. Defendants are prepared to produce the Nebraska documents as soon as that condition is satisfied. If Plaintiffs have obtained contrary information from the agency in Nebraska, they have not shared it with Defendants.

- State agencies in **Arizona, Delaware, Hawaii, Kansas, North Carolina, Ohio, Tennessee, Vermont, Wisconsin,** and **Wyoming** have notified Defendants that their documents may not be produced in this litigation in view of governing

[4] Despite Plaintiffs' efforts to depict Ms. Allcock as a key member of Household's senior management, her duties were limited to a single business unit at the Company.

confidentiality statutes or regulations. As a result, Defendants continue to withhold documents from these states; and for states other than Ohio (whose notification was not received until September 15) and Tennessee (whose notification was not received until September 14), they have issued recall letters to the Plaintiffs with respect of any inadvertently produced documents.[5]

- Although, as Plaintiffs report, agencies in **Iowa, Minnesota, New York** and **West Virginia** have "indicated that [they do] not want to be involved in what they see as a dispute between the parties," the implication that their documents are therefore open to disclosure is misplaced. In fact, each of these agencies specified that its supervisory materials are subject to confidentiality rules and should be withheld and/or recalled from production, and Iowa and New York have provided specific guidance as to which documents must be withheld from production. Defendants have complied with these instructions.

- Agencies in **New Mexico** and **Oregon** have not yet responded to our inquiries.

THE MAJOR PROBLEM WITH PLAINTIFFS' SHOWING

In struggling to explain why they wish to accumulate even more details about Household's branch-level operations, Plaintiffs begin with a telling statement that reveals the utter lack of focus and clarity that has allowed their "predatory lending" discovery to exceed all reasonable bounds, with no end to their demands in sight: "[A] central issue in this case", they say, "is whether Household engaged in predatory lending." Pl. Rep. at 3. Accordingly, they argue, a state agency's untested views about the performance of particular branch offices are by definition "highly relevant". That is simply wrong, and so long as Plaintiffs persist in treating this case as if they were prosecuting consumer fraud claims on behalf of individual borrowers,

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[5] Plaintiffs' accusation that Defendants failed to comply with the Protective Order's 10-day window for recalling inadvertently produced documents is off base, as Defendants have acted in every case within 10 days of receipt of instructions from the relevant state agency. As many states responded to our inquiries by authorizing production and use of supervisory-related documents, recalling documents before determining a state agency's position undoubtedly would have triggered complaints by Plaintiffs about premature or unduly broad recalls.

rather than a securities fraud case on behalf of shareholders supposedly harmed by deceptive disclosures, their obsessive focus on operational details will never be sated. And so long as Plaintiffs keep canceling depositions until collateral "state agency issues" are resolved, they will continue to evade the day of reckoning on their insubstantial securities fraud claims.

As the Court is aware from recent motion practice, Plaintiffs' ever-expanding demands for operational details are matched by an intense aversion to explaining an actionable nexus between alleged "predatory lending" (a term they concede has no standard meaning) and any negative impact on their clients' investments. This Court took an important step in helping to unravel that mystery by directing Plaintiffs to explain how they would propose to use these particular documents at trial. *See* Aug. 22, 2006 Status Conference Tr. 44:22-24 (ordering Plaintiffs to provide a status report containing a "clear statement on trial relevance" of the state agency documents). In these waning days of fact discovery, after Plaintiffs have received over four million pages of documents and have taken over 30 days of depositions (and counting), it was a proper exercise of discretion for this Court to require Plaintiffs to offer more than vague assurances of relevance to justify stalling further discovery while they pursue the relatively small body of state-restricted material. *See Lawrence E. Jaffe Pension Plan* v. *Household International, Inc.*, Fed. Sec. L. Rep. (CCH) P93,228, 2005 U.S. Dist. LEXIS 8610, at *6 (N.D. Ill. 2005) (Nolan, Mag. J.) ("Trial courts have broad discretion in resolving matters relating to discovery.") (citing *Patterson* v. *Avery Dennison Corp.*, 281 F.3d 676, 681 (7th Cir. 2002)).

Plaintiffs nevertheless dodged the Court's questions — ostensibly because they contest the imposition of a so-called "heightened standard", but more likely to conceal their real hope of inciting prejudice against Defendants at any eventual trial by keeping the jury's focus on untested "predatory lending" anecdotes and away from the elements of securities fraud. Merely stating that "the state agency reports and correspondence are probative at trial on the issue of scienter and falsity," Pl. Rep. at 4, provides no link between examinations of individual Household branch offices and the alleged defrauding of investors, and no answer to the Court's question about the cumulative nature of this material.

OTHER DEFICIENCIES IN PLAINTIFFS' REPORT

Plaintiffs fault Defendants for supposedly asserting privilege as to the subject documents, but this is plainly not the case. Rather, Defendants have informed Plaintiffs and the Court that they have been instructed to withhold or attempt to retrieve, in whole or in part, approximately 450 documents that certain states have declined to authorize for production. As Plaintiffs appear to recognize in suggesting that states be invited to brief their concerns, Defendants do not speak for the states, and Plaintiffs' quarrel with state-imposed restrictions should not be resolved without giving the relevant agencies an opportunity to be heard. Plaintiffs nevertheless argue the underlying issues at length and assert that this Court has sufficient basis now to compel the Company to defy its state regulators' express instructions. Pl. Rep. at 10. Without belaboring this subject in the absence of interested parties, for the Court's information Defendants will highlight some of the key errors in Plaintiffs' legal analysis.

A. Federal courts recognize a state's right to protect the confidentiality of its deliberative process.

Plaintiffs acknowledge that the starting point in evaluating an asserted protection from disclosure (in this instance, a state's wish to avoid disclosure of its deliberative processes) is an examination of the federal common law. Pl. Rep. at 6; s*ee also, e.g., Memorial Hospital for McHenry County* v. *Shadur*, 664 F.2d 1058, 1061 (7th Cir. 1981) ("[T]he question of whether the privilege asserted by the Hospital should be recognized in this case is 'governed by the principles of the common law as they may have been interpreted by the courts of the United States in the light of reason and experience.'") (quoting Fed. R. Evid. 501). However, Plaintiffs' contention that the federal common law extends no protection to state agency deliberations is simply wrong.

In making privilege determinations, federal courts have a duty to consider relevant state laws and expectations. "'A strong policy of comity between state and federal sovereignties impels federal courts to recognize state privileges where this can be accomplished at no substantial cost to federal substantive and procedural policy.'" *Memorial Hospital for McHenry County* v. *Shadur*, 664 F.2d at 1061 (quoting *United States* v. *King*, 73 F.R.D. 103, 105 (E.D.N.Y. 1976)). *Cf. Allen* v. *Chicago Transit Authority*, 198 F.R.D. 495, 502 (N.D. Ill. 2001) (looking to the views of Illinois state courts to determine whether the deliberative process privilege applies to Illinois state agency processes). Moreover, "where a state holds out the

expectation of protection to its citizens, they should not be disappointed by a mechanical and unnecessary application of the federal rule." *Memorial Hospital for McHenry County* v. *Shadur*, 664 F.2d at 1061 (quoted in *Addis* v. *Holy Cross Health Systems Corp.*, No. 3:94-cv-118RP, 1995 U.S. Dist. LEXIS 10122, at *11 (N.D. Ind. Feb. 7, 1995)). In short, a state's express views should not be summarily rejected by a federal court simply because a particular privilege has its origin in state law, especially where, as here, federal common law has embraced that privilege.

Federal common law recognizes the existence of a deliberative process privilege for federal *and* state governmental agencies. "The deliberative process privilege protects communications that are part of the decision-making process of a governmental agency . . . communications made prior to and as a part of an agency determination are protected from disclosure." *United States* v. *Farley*, 11 F.3d 1385, 1389 (7th Cir. 1993) (internal citations omitted) (holding that district court erred in permitting release of documents protected by the deliberative process privilege without establishing that the defendant had the requisite need). The deliberative process privilege protects "documents reflecting advisory opinions, recommendations and deliberations comprising part of a process by which governmental decisions and policies are formulated." *Hobley* v. *Burge*, No. 03 C 3678, 2006 U.S. Dist. LEXIS 55765, at *14 (N.D. Ill. May 24, 2006) (quoting *Department of Interior* v. *Klamath Water Users Protective Association*, 532 U.S. 1, 8-9 (2001)). The protection of the deliberative process privilege extends to reports of examination, among other documents. *See Armtek Corp.* v. *United States*, 94-CV-928S, 1996 U.S. Dist. LEXIS 9475, *7 (W.D.N.Y. Jun. 20, 1996) (holding that the deliberate process privilege protected IRS audit examination documents from disclosure).

There is no principled reason to exclude state agencies' deliberations from the deliberative process privilege, particularly where, as here, states have codified the confidentiality of their agencies' examination processes. *See, e.g.*, *Moorhead* v. *Lane*, 125 F.R.D. 680, 684-86 (C.D. Ill. 1989) ("The policy underlying the privilege recognized in federal courts for federal agencies supports the argument that the same privilege should be recognized for state agencies. This, combined with the emerging policy in the state of Illinois for recognition of such a privilege, persuades the court that it is proper to recognize an executive predecisional deliberative process privilege for state agencies."); *Bobkoski* v. *Board of Education,* 141 F.R.D.

88, 92 (N.D. Ill. 1992) ("Accordingly, we uphold Magistrate Judge Guzman's ruling that certain documents held by the defendant, a state entity, are potentially protectable under the deliberative process privilege and remand to the magistrate judge for that purpose."). *See also In re One Bancorp Securities Litigation*, 134 F.R.D. 4, 9 (D. Me. 1991) (holding that plaintiffs were not entitled to production of confidential state bank examination reports); *N.O.* v. *Callahan*, 110 F.R.D. 637, 642-43 (D. Mass. 1986) (applying protections of federal deliberative process privilege to internal state communications). Where, as here, the states at issue have directly applicable regulations restricting production of their documents, the federal common law deliberative process privilege applies.

B. The deliberative process privilege applies to the documents at issue here.

Household's consumer finance company business and its banking units were routinely examined by state and federal regulatory authorities, respectively, during the class period. To encourage candor in the on-going exchanges between regulator and supervised entity, both federal and state agencies impose specific statutory and regulatory restrictions deeming reports of examination and related documents to be deliberative materials, exempt from FOIA or other disclosure. *See, e.g.*, 12 C.F.R. § 4.26(d) ("No supervised entity . . . or agent thereof, may disclose non-public OCC information without the prior written permission of the OCC") (OCC); 12 C.F.R. § 510.5(c)(4)(v) ("All reports or other information made available to [regulated entities] shall remain the property of the OTS and, except as permitted by this section . . . no person . . . shall disclose any such information . . . .") (OTS); 12 C.F.R. § 309.6(a) ("In any instance in which any person has possession, custody or control of FDIC exempt records or information contained therein, all copies of such records shall remain the property of the Corporation and under no circumstances shall any person. . .disclose or make public in any manner the exempt records or information . . . .") (FDIC); 5 Del. C. § 145 ("All confidential supervisory information shall be the property of the Commissioner and shall be privileged and protected from disclosure to any other person and shall not be discoverable or admissible into evidence in any civil action.") (Delaware); H.R.S. § 412:2-104(e) ("All reports or other information made available pursuant to this section shall remain the property of the commissioner, and no person, financial institution or financial institution holding company, agency or authority to whom the information is made available, or any officer, director,

employee or agent thereof, shall disclose any of that information . . . .") (Hawaii). The language of the state regulations at issue here so closely tracks the analogous federal language that declining to extend the federal common law deliberative process privilege to state examinations would be entirely inconsistent with the rationale articulated by federal courts for protection of an agency's deliberative process.

Given the explicit guidance Defendants have received from the state agencies in question, there is no reason to believe that the documents Defendants were instructed to withhold or retrieve fall outside the scope of the applicable confidentiality regulations. For example, with respect to certain letters from a Household employee to the Department responding to examination recommendations, the Tennessee Department of Financial Institutions advised: "to the extent that these letters have reproduced any portion of an examination finding, those letters would be considered to be a record of the Department and subject to the confidentiality provisions of T.C.A. § 45-1-120." Likewise, a letter from the state agency in Kansas states: "it is our position that all correspondence to *and from* the licensee in response to an examination report constitutes part of the Administrator's private examination and should not be released."[6] (emphasis added). Moreover, the regulations of certain states address this specific issue; Delaware's confidentiality regulations, for example, extend to "any correspondence, communication or document, including any compliance and other reports, created by a financial institution in response to any request, inquiry or directive from the Commissioner." 5 Del. C. § 145.

Moreover, Defendants have provided every state that has instructed them to withhold and/or recall documents with copies of every withheld and/or recalled document, whether received from that state or created internally. The responses from the states overwhelmingly indicate that the withheld and/or recalled documents are protected by state confidentiality regulations (and any exceptions have been promptly produced by Defendants).

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[6] Consistent with state regulations and the guidance Defendants have received from the state agencies, internal documents were withheld or recalled where such documents were created at the behest of examiners or directly quoted or so closely paraphrased the findings in reports of examinations that their production would be tantamount to producing the reports of examination themselves.

Given the language of the state regulations and the guidance received from the state agencies themselves, there can be no question that the documents Defendants have withheld or recalled from production fall squarely within the scope of the federal common law deliberative process privilege. Whether Plaintiffs can meet the heavy burden of overcoming the states' interests in protecting such materials is a different question that is not ripe for determination now (although judging from the generalities Plaintiffs recite in their status report they seem highly unlikely to prevail).

PROPOSED NEXT STEPS

A The Protective Order should be modified to clarify that confidential state documents are within its scope.

The parties agree that the Protective Order should be modified to protect the confidentiality of state agency documents produced by Defendants. *See* Pl. Rep. at 2. The parties have also agreed on the language of that proposed modification. *Id.* The parties disagree, however, as to the scope of the modification, *id.*, in that Plaintiffs suggest that the modification be limited to the confidential documents of states that have expressly requested such a modification, while Defendants propose that the modification encompass confidential documents cleared for disclosure by any state, as set forth in the proposed draft. *See* Pl. Rep., Exhibit C.

Defendants propose that the Protective Order be modified to specify that its terms apply to documents authorized for production by state agencies and deemed confidential by them. Several of the agencies that have allowed disclosure of supervisory correspondence expressly relied upon the parties' assurances that the Protective Order would extend to documents that comprise or reflect their supervisory activities. It is reasonable to assume that clarifying the Protective Order in this way may give the remaining undecided states sufficient comfort to allow release of their restricted documents. Moreover, given the nature and contents of the documents at issue, relating both to the Company's internal business operations and individual customer information, these documents should be subject to protection whether or not a particular state made an explicit request to that effect.

B. Depositions should proceed now, with no further delay to accommodate Plaintiffs' pursuit of cumulative documents.

At some point earlier in this case, Plaintiffs made a decision to seek certain documents about Household's lending practices from selected state agencies. On an *ex parte* basis they pursued Freedom of Information Act requests in ten states, calling for production of documents relating to, *inter alia*, customer complaints against Household and state investigations of Household. The states processed these requests, based on Plaintiffs' follow-up communications (which they have refused to share with Defendants), culminating in the production of over 1,500 documents by states to Plaintiffs. In addition, Plaintiffs have obtained voluminous discovery from Defendants, and, as they readily admit, they have questioned the Company's witnesses about their dealings with state regulators, including Household's negotiations with state Attorneys General, without interference from Defendants.

Plaintiffs nevertheless imply that certain depositions should be deferred (in addition to the ones they have already adjourned) because a small number of states object to Household's disclosure of routine supervisory documents. Although Defendants will defer to the Court's wishes as to further briefing on the subject of state restrictions, they respectfully submit that Plaintiffs' pursuit of this narrow issue should not be accepted as an excuse to complicate or derail the conclusion of fact discovery.

Despite Plaintiffs' attempts to characterize this tempest in a teapot as a case-defining event, the generalities in their Status Report do not begin to make out a showing of relevance and need sufficient to overcome the states' interests in enforcing their confidentiality provisions, or to override the Company's interests in complying with its regulators' wishes and avoiding penalties for non-compliance. Nor have Plaintiffs explained why their quest for such a small number of inconclusive, cumulative, and probably inadmissible documents should take center stage in this litigation and threaten to slow down the completion of depositions. If Plaintiffs should move to compel Household to produce documents it has been barred from producing, Household will oppose such a motion and seek the Court's protection. And because Plaintiffs' likelihood of winning such a motion seems remote based on their superficial showing to date, the completion of fact discovery should not be slowed or stayed pending their exhaustion of this subject. If Plaintiffs voluntarily elect to back-burner more depositions while they pursue

this subject, they should be made to understand that they do so at their own risk, and that the Court expects them to complete their protracted discovery on time.

Dated: September 18, 2006
Chicago, Illinois

Respectfully submitted,

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CERTIFICATE OF SERVICE

Adam B. Deutsch, an attorney, certifies that on September 18, 2006, he caused to be served a copy of THE HOUSEHOLD DEFENDANTS' RESPONSE TO PLAINTIFFS' STATUS REPORT ON STATE AGENCY ISSUES, to the parties listed below via the manner stated.

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