FILED
MAY 13 2003
MICHAEL W. DOBBINS
CLERK, U.S. DISTRICT COURT

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.	)	

DOCKETED
MAY 16 2003

DEFENDANT ARTHUR ANDERSEN LLP'S MOTION TO DISMISS COUNTS I, III AND IV OF PLAINTIFFS' [CORRECTED] AMENDED CONSOLIDATED COMPLAINT

Defendant Arthur Andersen LLP ("Andersen") respectfully moves, pursuant to Federal Rules of Civil Procedure 9(b) and 12(b)(6), for an order dismissing with prejudice Counts I, III and IV of plaintiffs' [Corrected] Amended Consolidated Complaint ("Complaint") against it for failure to state a claim upon which relief may be granted.

In support of its motion, Andersen states the following grounds:

1. Count I of the Complaint, which purports to state a claim against Andersen under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, should be dismissed under Fed. R. Civ. P. 9(b) and 12(b)(6) because it does not state with particularity any false statements of fact made by Andersen and does not state with particularity any facts giving rise to a strong inference that Andersen acted with *scienter*, as required by Rule 9(b) and the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b)(2) ("PSLRA").

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2. Counts III and IV of the Complaint, which purport to state claims against Andersen under § 11 of the Securities Act of 1933, 15 U.S.C. § 77k, should be dismissed because such claims are barred by the applicable statutes of limitations and repose.[1]

In support of this motion to dismiss, Andersen hereby submits a Memorandum which is incorporated herein by reference.

WHEREFORE, Andersen respectfully requests that this Court dismiss Counts I, III and IV of plaintiffs' Complaint with prejudice as to Arthur Andersen LLP.

Dated: May 13, 2003

ARTHUR ANDERSEN LLP

By:
One of the Attorneys for Arthur Andersen LLP

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[1] Counsel for plaintiffs represented to counsel for defendant Arthur Andersen LLP that, although plaintiffs appear to allege Section 12 and 15 claims against Andersen in Counts III and IV, plaintiffs allege only Section 11 claims against Andersen.

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MEMORANDUM OF LAW IN SUPPORT OF DEFENDANT ARTHUR ANDERSEN LLP'S MOTION TO DISMISS COUNTS I, III AND IV OF PLAINTIFFS' [AMENDED] CONSOLIDATED CLASS ACTION COMPLAINT

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BACKGROUND

As the night follows the day, when a company restates its prior financial statements, as did Household International, Inc. ("Household" or the "Company"), class action lawyers will rush to the courthouse to file a securities fraud case (though it is noteworthy that not all of the class action complaints filed here named Arthur Andersen LLP ("Andersen") as a defendant). This is what precisely what occurred here. In an effort to prevent such unsubstantiated filings, Congress passed the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 (the "PSLRA"). To state a claim for securities fraud under the PSLRA, particularly with regard to an outside auditor such as Andersen, plaintiffs must allege more than the mere fact that Household restated its financial statements.[1] *See, e.g., Rothman v. Gregor,* 220 F.3d 81 (2d Cir. 2000) (concluding that fraud was pled as to company but not auditor in restatement case). Indeed, any other conclusion is precluded by the decision of the Seventh Circuit in *DiLeo v. Ernst & Young LLP,* 901 F.2d 624, 627 (7th Cir. 1990) ("Four billion dollars is a big number, but even a large column of big numbers need not add up to fraud.").

The rule that a restatement is not a sufficient predicate for a securities fraud complaint has particular relevance here. In this case, Andersen reported on Household's fiscal year-end financial statements for a number of years. In 2002, however, Household hired new auditors. Based on the new auditors' recommendations, and contrary to Andersen's views on 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. at ¶ 336. Household restated earnings to reflect the impact of the adjusted items. *Id.* See Ex. B hereto. In the same press release containing this announcement, Household also stated: "[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.*" *Id.* (emphasis added). The company further noted that "[t]he restatement, while

[1] *See,e.g., Abrams v. Baker Hughes, Inc.,* 292 F.3d 424, 433 (5th Cir. 2002); *Riggs Partners, LLC v. Hub Group, Inc.,* No. 02 C 1188, 2002 WL 3145721, at *9 (N.D. Ill. Oct. 25, 2002) (Judge Gettleman) (all unpublished opinions attached as Ex. A hereto); *In re SCB Computer Tech.,* 149 F. Supp. 2d 334, 353 (W.D. Tenn. 2001); *Cheney v. Cyberguard Corp.,* No. 98-6879-CIV-GOLD, 2000 WL 1140306, at *10 (S.D. Fla. July 31, 2000).

disappointing, is small relative to the results we have reported over the period 1993 through 2001." Thus, the restatement here reflected a difference of opinion over a complex accounting issue, had a small effect on the financial statements of Household, and did not cause the stock price to go down – all factors which further demonstrate that the requirements of the PSLRA have not been met. *See, e.g., Riggs Partners,* 2002 WL 3145721, at *8 (noting that only where no reasonable accountant could make the same decision is there an adequate securities complaint).

Nonetheless, shortly after that announcement of the restatement, the inevitable rush to the courthouse ensued, and seven purported class action complaints were filed against Household alleging that Household had been defrauding investors about its true financial condition. Only four of those complaints alleged that Andersen had been a participant in the alleged fraud. Recognizing that the matters subject to restatement did not suffice to bring a claim, when they filed the Complaint, the lead plaintiffs sought to expand their claim to include matters relating to predatory lending practices and improper aging of accounts The problem with these additional claims is that the same successor auditor who felt that there should be a change in accounting as to the affinity programs, did not recommend restatement of these amounts. The concurrence of the successor auditor in the treatment is powerful evidence that there is no fraud by Andersen with respect to these matters. *See Ikon Office Solutions Sec. Litig.*, 277 F.3d 658, 669 (3d Cir. 2002). For the reasons that follow, the Complaint should be dismissed with prejudice as to Andersen.

SUMMARY OF THE COMPLAINT

Plaintiffs' suit against Andersen epitomizes the type of lawsuit that Congress, by enacting PSLRA intended to eliminate. The 153-page, 398-paragraph Complaint relies on speculation, hindsight and innuendo to suggest that Andersen engaged in an ill-defined fraudulent conspiracy with Household's management to misstate Household's financial condition. Strictly for purposes of this motion, Andersen must assume to be true all of the facts alleged in the Complaint – the Complaint, however, does not allege *any facts* giving rise to *any* inference (much less the requisite "strong inference") that Andersen intentionally or recklessly misrepresented the results of its audit.

Significantly, the *only* representations Andersen made relating to Household's financial condition were its audit reports on Household's 1997-2001 year-end financial statements. *See,*

e.g., Cmplt. ¶¶ 173, 202, 227, 249, 279, 316. Despite the restatement, Andersen does not agree that the financial statements contained any errors, and the restatement is not evidence of any wrongdoing by Andersen. Also noteworthy, Household's subsequent auditor only recommended three revisions to Household's accounting practices: the treatment of (i) Household's MasterCard/Visa co-branding, (ii) an affinity credit card relationship, and (iii) a credit card marketing agreement with a third party. *See* Cmplt. at ¶ 134. Household's new auditor did not require any changes to Household's financial statements based on the alleged predatory lending and improper reaging of accounts referenced in the Complaint. Thus, those allegations have absolutely no connection with – nor any relevance to – any alleged wrongdoing by Andersen. They simply do not relate to any alleged misstatement made by Andersen. Further, none of the predatory lending or improper reaging allegations contains a single fact suggesting that Andersen possessed *any* knowledge regarding such practices. The Complaint contains no explanation of how an auditor would gain any information regarding a company's lending practices – much less any such allegations specific to Andersen.

Plaintiffs' claims against Andersen therefore relate to only a very few of the hundreds of paragraphs of the Complaint. In fact, the entirety of the allegations relating to Andersen's alleged accounting errors make up only *six* of the 398 paragraphs of the Complaint. In contrast, plaintiffs' allegations relating to fraudulent lending practices and the improper aging of delinquent accounts consume over *fifty pages*. *See, e.g.,* Cmplt. at ¶¶ 51-153.

Moreover, the allegations addressing the restatement concern relatively straightforward accounting discrepancies which simply cannot (and do not) amount to an intent to defraud Household investors. For example, regarding the allegedly improper co-branding agreements, plaintiffs allege, "Household, in violation of GAAP, inappropriately amortized the origination costs over the term of the agreement, thus spreading the cost of the origination fees paid to its partner over a longer period of time." Cmplt. at ¶ 138(a). Similarly, the allegations relating to the affinity agreement allege, "Household, in violation of GAAP, arbitrarily increased the amortization period for the premium, thus spreading the cost of the premium over a longer period of time." Cmplt. at ¶ 138(b). Finally, regarding the third-party marketing agreement, plaintiffs allege only that, "GAAP requires [the revenue-sharing payments] be recorded as incurred . . . Household, however, accounted for the revenue-sharing payments over a three-year period."

Cmplt. at ¶ 138(c). The result of these allegations is merely a disagreement over what period Household was to recognize expenses – it simply does not amount to fraud.

Specifically, Count I of plaintiffs' Complaint, for alleged violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, fails to plead a claim for relief against Andersen for three reasons. *First,* plaintiffs fail to plead particular facts showing that any of the statements in Andersen's audit opinions were false when made. *Second*, plaintiffs fail to plead particular facts giving rise to a strong inference that Andersen acted with scienter. *Third,* the Complaint fails to allege loss causation against Andersen. Not only does the Complaint fail to allege that any purported misrepresentation by Andersen caused plaintiffs' losses, the Complaint actually refutes any such theory by noting that the value of Household's stock increased on the day of the restatement. Plainly, if the value of the stock had been artificially inflated by Andersen's alleged accounting errors, Household's restatement of its earnings would have negatively impacted the value of the stock. Moreover, the Complaint alleges that the value of Household's stock was artificially inflated by Household's alleged predatory lending practices and reaging of delinquent accounts – neither of which can be attributed to Andersen.

In Count III, plaintiffs seeks relief against Andersen and others, for alleged damages under Section 11 of the 1933 Act for alleged false or misleading statements contained in Household's June 1, 1998 Form S-4 Registration Statement. Count IV is for alleged damages under Section 11 of the 1933 Act for alleged false or misleading statements contained in the registration statements filed in connection with the registration for sale and/or the sale of debt securities. All such claims are barred by the applicable statutes of limitations and repose.

ARGUMENT

I. COUNT I OF THE COMPLAINT MUST BE DISMISSED FOR FAILURE TO ALLEGE FACTS THAT ANDERSEN ACTED WITH THE REQUISITE SCIENTER

A. Rule 9(b) And The PSLRA Require That Plaintiffs Plead Specific Facts Giving Rise To A "Strong Inference" Of Scienter.

Federal Rule of Civil Procedure 9(b) requires that "the circumstances constituting [an alleged] fraud . . . shall be stated with particularity." Rule 9(b) "is especially designed to protect the reputation of accountants and other professionals from injury caused by unsubstantiated charges of fraud." *O'Brien v. Nat'l Prop. Analysts Partners*, 719 F. Supp. 222, 227 (S.D. N.Y.

1989). Even before passage of the PSLRA, courts applied the requirements of Rule 9(b) with vigor, especially in securities fraud cases challenging financial statements:

> Because only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financials statements and rest. Investors must point to some *facts* suggesting that the difference is attributable to fraud.

DiLeo, 901 F.2d at 627 (emphasis added).

The PSLRA made the requirements for pleading fraud even more demanding for securities fraud cases. *See Chu v. Sabratek Corp.*, 100 F. Supp. 2d 815, 823 (N.D. Ill. 2000). The PSLRA provides:

(1) "the complaint shall specify *each statement* alleged to have been misleading, [and] the reason or reasons *why* the statement is misleading," 15 U.S.C. § 78u-4(b)(1) (emphasis added), and

(2) "the complaint shall, *with respect to each act or omission* alleged to violate this chapter, state *with particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added).

In addition, "the court *shall,* on the motion of any defendant, dismiss the complaint if the requirements of paragraph (1) and (2) are not met." 15 U.S.C. § 78u-4(b)(3) (emphasis added).

Although the Seventh Circuit has not specifically addressed what is required to plead the requisite "strong inference" of scienter in a Section 10(b) case, cases in the Northern District of Illinois have generally followed the Second Circuit's pleading standard, which requires plaintiffs to allege facts either (1) showing that the defendant had both the motive and opportunity to commit fraud; or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness." *Riggs Partners,*[2] 2002 WL 3145721, at *4.

Although proof of recklessness has been held sufficient to establish scienter under Section 10(b), to show that an auditor has acted recklessly, a plaintiff must show that the auditor's conduct "approximate[s] an actual intent to aid in the fraud being perpetuated by the audited company." *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 121 (2d Cir. 1982). Thus, recklessness is conduct which is "highly unreasonable" and which represents an "extreme

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[2] With due respect, Andersen states that the Second Circuit test is now a minority view, and the majority standard is that of the Sixth Circuit (or the Ninth Circuit). *See Helwig v. Vencor, Inc.*, 251 F.3d 540, 552 (6th Cir. 2000) (en banc) ("inferences must leave little room for doubt as to misconduct").

departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant, or so obvious that the defendant must have been aware of it." *Riggs Partners*, 2002 WL 3145721, at *4. To establish recklessness, the plaintiff must "demonstrate that the deceit was committed with the intent to mislead or at least with recklessness *so severe that it is the functional equivalent of intent.*" *Sarles v. Glasser*, 64 F.3d 1061, 1066 (7th Cir. 1995) (emphasis added).

Recklessness is even "more onerous when the claim is brought against an outside auditor." *In re SmarTalk Teleservices, Inc. Sec. Litig.*, 124 F. Supp. 2d 505, 514 (S.D. Ohio 2000). Where claims against an independent auditor are involved:

> Scienter requires more than a misapplication of accounting principles. The plaintiff must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or 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.

Id. at 514 (quoting *Reiger v. Altris Software, Inc.*, 1999 WL 540893, at *4 (S.D. Cal. Apr. 30, 1999) ("*Reiger I*")). Further:

> When the standard of recklessness for an auditor is overlaid with the pleading requirements of the PSLRA, a simple rule emerges: to allege that an independent accountant or auditor acted with scienter, *the complaint must allege specific facts showing that the deficiencies in the audit were so severe that they strongly suggest that the auditor must have been aware of the corporation's fraud.*

Id. at 514 (emphasis added) (quoting *Reiger I*, 1999 WL 540893 at *5). To make such a showing the complaint "must identify *specific, highly suspicious facts and circumstances available to the auditor at the time of the audit* and allege that these facts were ignored, either deliberately or recklessly." *Id.* at 515 (emphasis added). Stated otherwise, the facts must be such that "no reasonable accountant would have made the same decisions if confronted with the same facts." *Riggs Partners*, 2002 WL 3145721, at *7.

B. The Complaint Fails To Allege False Statements By Andersen Or A Strong Inference Of Scienter.

The Complaint attempts to allege scienter through unsubstantiated conclusions that Andersen was financially motivated to misrepresent Household's financial condition; Andersen

had access to information confirming the existence of alleged predatory lending practices and improper reaging of delinquent accounts by Household; the alleged violations of GAAP and GAAS demonstrate scienter on the part of Andersen; and, because other suits against Andersen have alleged fraud, Andersen committed fraud in this case.[3] However, *none* of plaintiffs' unsubstantiated allegations can create a strong inference of scienter.

1. **Plaintiffs' Motive Allegations Are Insufficient To Establish A Strong Inference Of Scienter.**

Plaintiffs make no effort whatsoever to allege that Andersen had any actual motive to commit fraud on Household's behalf or benefited in any way from such fraud. The Complaint merely alleges that Andersen earned fees from its auditing and consulting work for Household and wished to keep Household as a client. *See* Cmplt. at ¶¶ 46, 177, 178. The same motives could be ascribed to any accounting firm in virtually any case – auditors, like other professionals, always earn fees and always wish to retain their clients. For that reason, such boilerplate allegations are insufficient to allege scienter on the part of auditors. *See DiLeo*, 901 F.2d at 628-29.[4] That is particularly true, as here, when the plaintiffs do not allege that the fees earned were extraordinary in size or were tied into more lucrative consulting services. Having failed to establish motive, the issue here is whether plaintiffs have adequately alleged that Andersen's

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[3] We deal with the allegations relating to other lawsuits in our separate Motion to Strike. In addition, because the issue of scienter is closely tied to whether the Complaint even alleges a false statement of fact by Andersen, we also combine the discussion of falsity with that of scienter.

Most of plaintiff's allegations have no specificity whatsoever. For example, plaintiffs assert that Andersen knew that Household's disclosures were false. *See* Cmplt. at Section VIII(E), pp. 67-68. However, there is nothing whatsoever to support that naked assertion Likewise, plaintiff alleges that Andersen violated professional standards. *See* Cmplt. at Section VIII(F), pp. 68-70. Not only does a violation of professional standards not equate to securities fraud, *Robin v. Arthur Young*, 915 F.2d 1120, 1126 (7th Cir. 1990), but there is no factual support for the assertion that Andersen violated professional standards. Plaintiffs state that Andersen disregarded indicators of fraud – red flags. *See* Cmplt. at Section VIII(D), pp. 65. But the only red flag noted is that the officers' compensation was tied to the revenues of the company. This is not what other courts have considered a red flag since it is true for many companies and does not suggest that there was anything wrong with the accounting at Household.

[4] *See also, e.g., Melder v. Morris,* 27 F.3d 1097, 1103 (5th Cir. 1994); *Danis v. USN Communications,* 121 F. Supp.2d 1183, 1195 (N.D. Ill. 2000); *Reiger v. Price Waterhouse Coopers ("Reiger II"),* 117 F. Supp. 2d 1003, 1007-08 (S.D. Cal. 2000) (plaintiff alleging scienter against auditor must "overcome irrational inference that the accountant would risk its professional reputation to participate in the fraud of a single client.").

audits were so deficient they evidence recklessness that "approximates an actual intent to aid in [Household's alleged] fraud." *SmarTalk*, 124 F. Supp. 2d at 514 (citations omitted).

2. The Complaint's Allegations Regarding Andersen's Access To Unspecified Information Are Insufficient To Raise A Strong Inference Of Scienter.

The Complaint asserts that unnamed Andersen personnel "were present" at Household's corporate headquarters and had access to unspecified "confidential corporate financial and business information." Cmplt. at ¶¶ 46, 171. The Complaint fails to allege which Andersen personnel were present, which of these corporate documents were allegedly seen or what corporate information allegedly was known by Andersen. *Id.* Such vague allegations of access to information are simply insufficient to allege securities fraud. *See, e.g., Zucker v. Sasaki*, 963 F. Supp. 301, 306, 309 (S.D. N.Y. 1997); *see also Riggs Partners*, 2002 WL 3145721, at *8. It is "implausible to assert that because an accountant had access to a company's internal data, it by implication was aware of any fraudulent scheme." *Queen Uno Ltd. P'ship v. Coeur d'Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1360 (D. Colo. 1998). All auditors are presumed to be familiar with records of the companies they audit and to spend time at company offices. Inferring knowledge of, and an intent to further, a fraudulent scheme based on such access would subject any accountant or high-ranking company official to liability for any fraud committed by others. Thus, a "defendant's access, even if unfettered access to records 'is an inadequate basis for scienter, one which would expose virtually any CEO, by virtue of his or her position alone, to liability.'" *In re Comshare, Inc. Sec. Litig.*, No. 96-73711-DT, 1997 WL 1091468, at *8 (E.D. Mich. Sept. 18, 1997), *aff'd* 183 F.3d 542 (6th Cir. 1999).

3. Plaintiffs' Allegations Regarding Andersen's Alleged Violations Of GAAP And GAAS Are Insufficient To Raise A Strong Inference Of Scienter.

To allege scienter by an accountant or auditor, it is not enough to allege that the financial statements contained errors. *Riggs Partners,* 2002 WL 3145721, at *9. Moreover, as multiple circuits have instructed, "[t]he failure to follow GAAP is, by itself, insufficient to state a securities fraud claim." *Comshare*, 183 F.3d at 533; *see also Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 432 (5th Cir. 2002) ("the mere publication of inaccurate accounting figures or failure to follow GAAP, without more, does not establish scienter"); *Navarre Corp. Sec. Litig. v. Navarre Corp.*, 299 F.3d 735, 745 (8th Cir. 2002) ("Allegations of GAAP violations are

insufficient, standing alone, to raise an inference of scienter . . . Only where these allegations are coupled with evidence of corresponding fraudulent intent might they be sufficient.").[5]

Even before the PSLRA, courts consistently recognized that "allegations that an accountant or auditor conducted an inadequate audit by violating accounting or auditing principles do not, without more, adequately plead a strong inference of scienter." *Reiger I,* 1999 WL 540893 at *7; *see also In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994) (stating that the "mere publication of inaccurate accounting figures," does not give rise to liability under § 10(b)). In cases such as this one, where allegations of fraud amount to nothing more than allegations of improper revenue recognition or general accounting errors, courts routinely find such allegations insufficient to establish a strong inference of scienter. *See Riggs Partners*, 2002 WL 3145721, at *9; *Dura Pharm., Inc. Sec. Litig.*, No. 99CV0151-L, 2000 WL 33176043, at *9, (S.D. Cal. July 11, 2000).[6] For example, to demonstrate a claim based on improper revenue recognition, the plaintiffs must plead how revenue was improperly recognized on a particular contract. *See Greebel v. FTP Software,* 194 F.3d 185, 203-04 (1st Cir. 1999). That is not done here. Thus, plaintiffs may not rely solely on alleged GAAP and GAAS violations – as they attempt to do – to plead scienter. In any event, the Complaint does not even adequately plead violations of GAAS.

To comply with the reform act, plaintiffs must specify how each of Andersen's audits were not performed in accordance with GAAS and why Andersen "could not reasonably and in

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[5] "GAAP is not [a] lucid or encyclopedic set of pre-existing rules." *Shalala v. Guernsey Mem. Hosp.*, 514 U.S. 87, 101 (1995). Rather, GAAP "encompasses the conventions, rules, and procedures that define accepted accounting practice at a particular point in time," and "is often indeterminate." *Id.* There are no less than "19 different GAAP sources, any number of which might present conflicting treatments of a particular accounting question," *id.*, and within those sources, a typical audit report is "based on the auditor's interpretation and application of hundreds of professional standards, many of which are broadly phrased and readily subject to different constructions." *Bily v. Arthur Young & Co.*, 834 P.2d 745, 763 (Cal. 1992).

[6] Andersen submits that this Court should not even consider the fact that there was a restatement as to Household since the fact of a restatement is not inadmissible because it is a subsequent remedial measure. *See Malone v. Microdyne Corp.*, 26 F.3d 471, 478-80 (4th Cir. 1994) (holding that a revised Form 10-K is a subsequent remedial measure that cannot be used to prove negligence or culpable conduct in connection with the original Form 10-K); *Krouner v. Amer. Heritage Fund, Inc.*, 899 F. Supp. 142, 147 (S.D. N.Y. 1995) (same, as to subsequent prospectus). And, because Andersen did not make or agree to the restatement it is not an admission against Andersen *at all*. *See Beck v. Cantor, Fitzgerald & Co,* 612 F. Supp. 1547, 1566 (N.D. Ill. 1985).

good faith opine that the financial statements as a whole fairly presented the financial condition of [Household] in accordance with GAAP." *In re Westinghouse Sec. Litig.*, 90 F.3d 696, 712 (3d Cir. 1996). Plaintiffs never link the alleged GAAP violations to specific, highly suspicious facts and circumstances available to Andersen at the time of its audits that should have alerted Andersen to the alleged inaccuracies. *See, e.g., Reiger I*, 1999 WL 540893 at *7. Thus, the Complaint does not adequately plead any violation of GAAS by Andersen, much less facts showing that the alleged audit deficiencies "were so severe that they strongly suggest that [Andersen] must have been aware of [Household's] fraud." *SmarTalk*, 125 F. Supp. 2d at 514 (internal citations omitted).[7]

The allegations regarding GAAS are boilerplate, quoting or paraphrasing an auditing standard and stating that Andersen "knowingly or recklessly" violated it, without alleging *any* facts whatsoever about what Andersen did, did not do, or should have done differently. *See* Cmplt. at ¶¶ 46, 171-79. Plaintiffs allege only that Andersen was "intimately familiar with Household's business affairs," using very generic allegations that would apply to any auditor. (*E.g.*, Andersen "was involved in various facets of Household's business . . . Andersen audited Household's financial statements, prepared Household's tax returns and provided consulting services on a wide range of topics," Cmplt. at ¶ 171).[8] This paragraph obviously does nothing to establish a violation of GAAS, let alone scienter. The next paragraph, 172, adds only a conclusory statement that Andersen "turned its back on its responsibilities to Household

[7] The restatement amounted to a decrease of $386 million in earnings over a 7 ½ year period, or an average of $51.5 million per year. While the average investor likely would not consider this "pocket change," it is not an amount sufficient to establish fraud. *See DiLeo*, 901 F.2d at 627 ("[f]our billion dollars is a big number, but even a large column of big numbers need not add up to fraud"); *In re Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 151-52 (D. Mass. 2001) (accounting error amounting to 20% of pre-tax income not sufficient to constitute fraud, especially "in the wake of the passage of the PSLRA").

[8] There are no allegations, of course, to suggest Andersen learned anything during the course of its "consulting" and/or tax work that demonstrates knowledge of any impropriety at Household. Absent such knowledge, the fact that Andersen might have done consulting work is of no import. *See Danis, supra*, 121 F. Supp. 2d at 1193-94. While it may be popular to assert that independence has been compromised by the rendition of non-audit services, *see* Cmplt. at ¶¶ 177-179, the rendition of consulting services does not provide support for the conclusion that an audit was fraudulent, particularly not when, as here, there is no allegation that the work that was being performed was in any way in violation of professional standards at the time.

investors and the investing public and abandoned its professional standards by helping Household perpetrate the massive accounting fraud alleged herein." Ignoring the case law discussed above, plaintiffs then conclude that "Andersen's issuance of, and multiple consents to reissue materially false reports on, Household's 1997-2001 financial statements were themselves violations of GAAS." Cmplt. at ¶ 173. Plaintiffs cannot rely on the restatement to establish violation of GAAS, particularly not when the restatement relates only to a disagreement about complicated accounting determinations, *see Riggs Partners*, 2002 WL 3145721, at *9, and Plaintiffs have not asserted any factual basis to establish a "strong inference" of scienter. Count I against Andersen should be dismissed with prejudice.

II. COUNT I OF THE CONSOLIDATED COMPLAINT MUST BE DISMISSED AGAINST ANDERSEN FOR FAILURE TO ALLEGE LOSS CAUSATION

A Section 10(b) claim requires a plaintiff to allege facts showing that the purported misrepresentations *caused* the losses he ultimately incurred. *See, e.g., Fryling v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 593 F.2d 736, 743-44 (6th Cir. 1979). The loss causation requirement ensures that a defendant is not held liable for losses caused by market risks or other events independent of the alleged fraud. *See, e.g., Bastian v. Petren Res. Corp.*, 892 F.2d 680, 684-85 (7th Cir. 1990) ("If the plaintiffs would have lost their investment regardless of the fraud, any award of damages to them would be a windfall.") In *Bastian*, the Seventh Circuit affirmed dismissal of a Section 10(b) complaint for failure to plead loss causation, "[w]ith respect to the Rule 10b-5 charge [the district judge] found a more serious deficiency: a failure to allege 'loss causation' – that is, *that if the facts had been as represented by the defendants the value of the limited partnerships would not have declined.*" *Id.* at 682 (emphasis added). Thus, if plaintiffs would have suffered their losses regardless of defendant's representations, the representations cannot be the "cause" of plaintiffs' loss.

Accordingly, it is not sufficient merely to allege that a plaintiff purchased stock at a price artificially inflated by false information. The plaintiff must also allege facts showing the defendant's misrepresentations caused the plaintiff to incur a loss and that plaintiff's loss was not caused by business reversals or other factors. *See LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 931 (7th Cir. 1988) ("'Loss causation' means that the investor would not have suffered a loss if the facts were what he believed them to be"); *In re Crossroads Sys., Inc.*, No. A-00-CA-457, 2002 WL 32005236, at *1 (W.D. Tex. Nov. 22, 2002) (employing two-day window to determine whether stock price fell following announcement of alleged misrepresentation); *Cole*

v. Fed. Home Loan Mortgage Corp., No. 90-2812, 1999 WL 180295, at *3 (D.D.C. Aug. 27, 1991) (allegation stock price artificially inflated insufficient to show loss causation where price declined due to unrelated factors). "Where there is a genuine dispute as to the reasons for the failure of a project . . . , a plaintiff must allege loss [causation] with greater particularity; and those allegations must appear in the complaint, subject to Rule 11 scrutiny." *Finkel v. Stratton Corp.*, 754 F.Supp. 318, 330 (S.D. N.Y. 1991) (citation omitted), *aff'd in part and rev'd in part on other grounds*, 962 F.2d 169 (2d Cir. 1992). Judged by these standards, Count I fails to pass muster. First, the Complaint acknowledges that, on the date of the restatement, Household's stock closed up. *See* Cmplt. at ¶ 140. Moreover, the Complaint itself supports the fact that any decline in the value of Household's stock is not attributable to the restatement. Rather, the Complaint attributes the decline in the value of Household stock to the alleged predatory lending practices, reaging of delinquent accounts and various other representations and statements made by Household. *See, e.g.*, Cmplt. at ¶¶ 6, 29, 210, 219, 224, 230, 234, 264. These allegations show plaintiffs would have suffered their losses regardless of whether the audited financial statements contain any misstatement. Accordingly, Count I must be dismissed.[9]

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[9] Similarly, Counts III and IV also should be dismissed. Since the restatement in fact produced a more favorable result and plaintiffs attribute the ultimate decline in value of Household stock to other factors, under Section 11(e) of the 1933 Act and the principles of loss causation, Counts III and IV must be dismissed.

Section 11(e) of the 1933 Act provides:

> [I]f the defendant proves that any portion or all of such damages represents other than the depreciation of value of such security resulting from such part of the registration statement, with respect to which is liability is asserted, . . . such portion of or all such damages shall not be recoverable.

15 U.S.C. § 77k(e). Thus, Section 11(e) affords a defendant the possibility of avoiding liability when the defendant shows that factors other than his alleged false statements or omissions caused the decline in the value of the stock for which plaintiffs seek to recover. *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 340-44 (2d Cir. 1987) (affirming summary judgment where defendants established, *inter alia*, that public failed to react adversely to its disclosure); *In re Fortune Sys. Sec. Litig.*, 680 F. Supp. 1360, 1364-68 (N.D. Cal. 1987) (affirming summary judgment where defendants established that forces other than the defendants' actions caused the decline in stock value). The doctrine of loss causation, as applied under Section 11, requires that a plaintiff's damages "must be the direct result of the misrepresentations or omissions" made by the defendant. *In re Fortune Sys. Sec. Litig.*, 680 F. Supp. at 1365.

Since plaintiffs affirmatively pleaded that Household's stock price increased on the date of the restatement, plaintiffs' alleged damages cannot be the direct result of Andersen's alleged conduct. Accordingly, plaintiffs have pleaded themselves out of any Section 11 claim. *Thomas v. Farley*, 31 F.3d

(cont'd)

III. COUNTS III AND IV AGAINST ANDERSEN MUST BE DISMISSED BECAUSE SUCH CLAIMS ARE BARRED BY THE APPLICABLE STATUTE OF LIMITATIONS AND REPOSE

In Counts III and IV, plaintiffs' claims are based upon Section 11 of the 1933 Act (Cmplt. at ¶¶ 354-394). Section 11 of the 1933 Act creates civil liability for "an untrue statement of a material fact or omi[ssion of] a material fact" in a registration statement. 15 U.S.C. § 77k. Section 11 liability does not depend on fraud. *Id.*; *Schoenfeld v. Giant Stores Corp.*, 62 F.R.D. 348 (S.D. N.Y. 1974) (plaintiff does not have to allege or prove fraud or deceit in a Section 11 claim). Pursuant to the terms of Section 13 of the 1933 Act, to state a claim under Section 11 of the 1933 Act, plaintiffs must be able to demonstrate not only that they filed their action within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, but also that the filing occurred within three years after the securities were first bona fide offered to the public. 15 U.S.C. § 77m; *In re Chaus Sec. Litig.*, 801 F. Supp. 1257, 1265 (S.D. N.Y. 1992) ("Compliance with this limitations period is an essential, substantive element of a claim under Sections 11 and 12(2)"); *Finkel v. Stratton Corp.*, 962 F.2d 169, 174 (2d Cir. 1992) (affirming dismissal based upon 3 year statute of repose).

The Lead Plaintiffs completely fail to plead compliance with the one year and three year statute of limitations. Instead, they only allege that they have brought the claim with two years of their discovery of the misstatements and with three years of the time the securities were offered. Complt. at ¶ 381. *See also* Count IV (Cmplt. at ¶ 394). Not only are their allegations insufficient to comply with the pleading requirements, but the allegations are based upon the wrong statute of limitations. Further, the plaintiffs themselves allege that, when this lawsuit was filed in 2002, more than three years had passed since the securities were bona fide offered to the public and/or since the sale in 1998. 15 U.S.C. § 77m; Cmplt. at ¶ 357. Since, "in the context of securities litigation, if a plaintiff pleads facts that show its suit is barred by a statute of limitations, it may plead itself out of court under a Rule 12(b)(6) analysis," Counts III and IV

(... cont'd)

557, 558-59 (7th Cir. 1994). The Section 11 claims against Andersen within Counts III and IV must be dismissed.

should be dismissed. *Whirlpool Fin. Corp. v. GN Holdings, Inc.*, 67 F.3d 605, 610 (7th Cir. 1995) (affirming dismissal of Section 12(a)(2) claim).

It is plain that the only way that these claims are not time barred is if the statute of repose is not three years. In conversations with plaintiffs' counsel, that is the position of the plaintiffs who claim somewhat incredibly that the Sarbanes-Oxley Act modifies the specific statute of limitation periods for Section 11 claims contained within Section 13 of the 1933 Act. The statute plainly does nothing of the sort. The Sarbanes-Oxley Act states that:

> [A] private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws may be brought not later than the earlier of: (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation.

Pub. L. No. 107-204, amending 28 U.S.C. § 1658(b). Accordingly, securities claims involving "fraud, deceit, manipulation, or contrivance" will be subject to the new, broader statute of limitations. *Id.* The terms utilized in the Sarbanes-Oxley Act – fraud, deceit, manipulation and contrivance – have specific, narrow meanings in securities law and "proscribe a type of conduct quite different from negligence." *Ernst & Ernst v. Hochfelder et al.*, 425 U.S. 185, 199 (1976). For example, manipulation "is and was virtually a term of art when used in connection with securities markets. It connotes *intentional* or *willful* conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Id.* (emphasis added). Device means "[t]hat which is *devised*, or *formed by design*; a *contrivance*; an invention; project; *scheme*; often, a scheme to deceive . . . ." *Id.* at 199 n.20 (emphasis added). Thus, for example, the Sarbanes-Oxley Act broadened the statute of limitations for claims under Section 10(b) of the Securities Exchange Act of 1934 ("manipulative and deceptive devices") because such claims specifically require allegations of "manipulative or deceptive device or contrivance" for liability. 15 U.S.C. § 78j(b); *see also Ernst & Ernst*, 425 U.S. at 193-214 (private action for damages fails under Section 10(b) absent allegations of intent to deceive, manipulate, or defraud).

Section 11 claims, on the other hand, require no such allegations. Section 11 claims do not depend on fraud, and there is no requirement that a plaintiff plead and prove an intent to deceive, manipulate, or contrive. Rather, a Section 11 plaintiff must plead only an untrue statement of material fact or an omission of a material fact. *Id.* Plaintiffs, themselves, recognize that the Sarbanes-Oxley Act statute of limitations are inapplicable to their claims by expressly excluding any allegations of intentional conduct. Cmplt. at ¶ 354 ("Plaintiffs expressly exclude

any allegation complained of herein that could be construed to allege intentional or reckless conduct."); ¶ 383 ("For purposes of this Claim for Relief, plaintiffs expressly exclude and disclaim any allegations that could be construed as alleging fraud or intentional or reckless misconduct . . . ."). Without alleging intentional conduct, plaintiffs leave allegations of only strict liability or negligence – conduct quite different from that associated with terms like manipulative, device and contrivance. Accordingly, plaintiffs specifically allege conduct outside the ambit of the Sarbanes-Oxley Act and cannot now claim the benefit of its statute of limitations. *Ernst & Ernst*, 425 U.S. at 199.

Moreover, Section 13 continues to govern Section 11 claims because there is nothing within the Sarbanes-Oxley Act repealing, specifically modifying or even addressing Section 13's limitation periods. In addition, as stated *supra*, Section 13 explicitly sets a statute of limitations for Section 11 claims ("No action shall be maintained to enforce any liability created under [section 11] unless brought within one year . . . .) while the Sarbanes-Oxley Act generally provides a limitations period for claims involving fraud, deceit, manipulation, or contrivance. It is a well-established canon of statutory construction that when two statutes arguably cover the same situation, the more specific statute (Section 13) takes precedence over the more general one (Sarbanes-Oxley Act). *Edmond v. United States*, 520 U.S. 651, 657 (1997) ("Ordinarily, where a specific provision conflicts with a general one, the specific governs."). Accordingly, Section 13 remains in force and Counts III and IV should be dismissed with prejudice.[10]

Counts I, III and IV of the Complaint, with respect to Arthur Andersen LLP, should be dismissed with prejudice.

Dated: May 13, 2003

Respectfully Submitted,

ARTHUR ANDERSEN LLP

By:
One of the Attorneys for Arthur Andersen LLP

[10] While clarity of the language of the statute makes recourse to legislative history inappropriate, we note that in introducing the statute on the floor, as part of the official legislative history of the statute, Senator Leahy unambiguously stated: "It applies to all private securities fraud actions…" 148 Cong. Rec. S7418-01 (July 26, 2002) (statement of Sen. Lahey). Section 11 does not meet this definition.

SEE CASE FILE FOR EXHIBITS