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

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

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I. INTRODUCTION

Lured by millions of dollars in auditing and consulting fees, defendant Arthur Andersen LLP ("Andersen") abandoned its function as independent "public watchdog" for the investing public. Instead of doing its job – identifying and disclosing Household International, Inc.'s ("Household" or the "Company") pervasive fraudulent scheme, including severe accounting irregularities – Andersen willingly turned its head, affirmatively made false representations of its own, and now pleads ignorance, asking this Court to dismiss particularized fraud allegations against it for failing to state a claim.

Andersen was Household's long-term auditor and consultant and was intimately familiar with Household's business. Because of Andersen's role, it had access to a great number of highly suspicious facts strongly indicating that Household was engaged in fraudulent activities and was improperly accounting for its business, in many instances with Andersen's blessing. Yet Andersen ignored these warning signs and conducted an "audit" that was so deficient, that it amounted to no audit at all. At best, Andersen was extremely reckless. At worst, Andersen consciously turned a blind eye to the fraud to maintain its significant auditing and consulting fees. In any event, Andersen violated its responsibility to the public. Because the Complaint[1] particularly alleges these facts, Andersen's motion to dismiss must be denied.

II. ANDERSEN'S ACCESS TO INFORMATION AND ITS DUTY TO INVESTORS

A complete statement of facts, detailing the massive fraud at Household which was comprised of predatory lending practices, improper reaging of delinquent loans and false accounting, is included in Plaintiffs' Response to Household Defendants' Motion to Dismiss [Corrected] Amended Consolidated Class Action Complaint ("Pltfs' Household Resp."), §§II.A-C. This brief will focus on the Complaint allegations as they specifically relate to Andersen.

A. Andersen Was Intimately Familiar with Household's Business

Andersen had been Household's auditor since 1985, more than a decade before the Class Period[2] even began. ¶¶46, 171; *see also* Household's 1985 Report on Form 10-K at F-1 (Ex. A attached hereto). It examined and opined on the accounting integrity of Household's quarterly and annual financial statements, and reviewed Household's interim results and releases. ¶171. Additionally, Andersen played a central role in Household's numerous acquisitions, including the Beneficial Corporation merger valued at $8 billion. ¶¶9, 171, 173-75, 370.

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[1] "Complaint" refers to plaintiffs' [Corrected] Amended Consolidated Class Action Complaint for Violation of the Federal Securities Laws, filed on 3/13/03. All paragraph references ("¶_") herein are to the Complaint, unless otherwise indicated.

[2] The Class Period is from 10/23/97 to 10/11/02.

Andersen was not just Household's auditor. It also prepared Household's tax returns and provided year-round consulting services on a wide range of topics. ¶¶46, 171. Andersen personnel were present at Household's headquarters and financial offices throughout the year and had continual access to confidential corporate, financial and business information. *Id.*

Specifically, Andersen was routinely involved in the ***structuring and/or approval of Household's practices and debt offerings*** and discussed and approved Household's press releases related to the dissemination of Household's financial results. ¶¶171, 176. In 2000 and 2001 alone, Household paid Andersen a total of $8.5 million, ***more than half of which was for non-auditing fees.*** ¶177. Simply put, Andersen did not come in once a year to check Household's math. ¶¶46, 171. Rather, it provided day-to-day financial advice to a company whose primary business was consumer lending. ¶¶46, 164, 171.

B. Andersen Had a Public Responsibility to Verify the Accuracy of Household's Financial Reports

As Household's independent auditor, Andersen not only had a duty to Household to properly audit the Company's books, but also had a duty to the public. The U.S. Supreme Court has stressed the importance of auditor independence, stating that "[b]y certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a ***public*** responsibility transcending any employment relationship." *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984) (emphasis in original). An independent accountant serves the function of a "public watchdog." *Id.* at 818.

This obligation was not changed by the Private Securities Litigation Reform Act of 1995 ("PSLRA"). *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 673 (S.D. Tex. 2002) (citing *Arthur Young & Co.*, 465 U.S. at 817-18); *In re MicroStrategy Inc. Sec. Litig.*, 115 F. Supp. 2d 620, 655 (E.D. Va. 2000). As an independent auditor, Andersen continued to owe a duty to the investing public to verify the accuracy of Household's financial reports.

C. Andersen Represented that It Conducted a Comprehensive Audit

Andersen represented in its audit reports that it had ***examined, on a test basis, evidence supporting the amounts*** and disclosures in the financial statements. ¶¶174-75. Because Household's primary business was consumer lending, ¶¶16, 107, 164, it is reasonable to infer that "test" examinations of accounts included verifying the various components of mortgage and consumer loan agreements that were entered into with consumers and verifying outstanding loan balances, interest rates, and other fees generated.

In a sampling of loan terms and loan balances, Andersen would have had access to, and should have detected, the unusually high percentage of Household's reaged loans (*i.e.*, over 27% of "non-credit card" debt). ¶¶123, 127, 323; Consent Decree, ¶¶9-10 (attached as Ex. 2 to Plaintiffs' Request for Judicial Notice ("RJN"), filed herewith). This high percentage was ***inconsistent*** with

Household's reported delinquency rates and about 50% lower than other subprime mortgage lenders, such as Providian Financial Corp. and AmeriCredit Corp. ¶¶14, 123, 124, 127, 128.

A sampling of loan agreements would also have revealed that Household's real estate loans regularly added 7 to 8 points (up-front payments that "buy down" interest rates, correlating to 1% of the loan amount), ***without a corresponding buy-down of the interest rate*** and included these ***up-front*** fees ***in*** the loan amount. ¶¶61-65. Moreover, an examination, "on a test basis," would also have shown an unusually large percentage of real estate loans carrying insurance (insurance penetration was 60% to 75%; in some parts of the country, even as high as 92% to 100%). ¶¶72-73. It would further have shown that borrowers were taking out loans equal to or higher than their home equity, including loans with 125% loan-to-value ratios, and that borrowers were taking out secondary loans with interest rates of 20% or higher at the time that they were taking out their first mortgage loans. ¶¶51, 75-78. In sum, even the most perfunctory testing of the data behind the accounting results presented would have alerted Andersen to the possibility of Household's fraud -- and the need to examine Household's numbers more closely.

III. ARGUMENT

A. Standard of Review

A complaint should not be dismissed unless it appears "beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson,* 355 U.S. 41, 45-46 (1957).[3] In considering a motion to dismiss, the court accepts as true plaintiffs' well-pleaded factual allegations and draws all reasonable inferences in favor of the plaintiffs. *Pickrel v. City of Springfield, Ill.,* 45 F.3d 1115, 1117 (7th Cir. 1995). The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims. *Id.* at 1118.

B. Andersen Was Directly Involved in the Accounting Improprieties Leading to the Restatement

Plaintiffs allege that Andersen had direct knowledge of the specific, highly suspicious facts regarding Household's improper accounting. ¶¶135, 182; *see also* 8/14/02 Household conference call transcript at 2 (Ex. B attached hereto).[4] Andersen does not dispute this. Andersen Def's Mem. at 1-4.[5] The improper accounting resulted in a restatement whereby Household had to take a charge

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[3]Here, as elsewhere, footnotes and citations have been omitted and any emphasis has been added, unless otherwise indicated.

[4]The district court may consider documents incorporated by reference to the pleadings. *United States v. Wood*, 925 F.2d 1580, 1581 (7th Cir. 1991).

[5]"Andersen Def's Mem." refers herein to the 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.

of $600 million, wiping out $386 million in previously reported earnings. ¶¶5, 135-36, 336, 343. Andersen also does not dispute this. Andersen Def's Mem. at 10 n.7.

The restatement was mandated by Generally Accepted Accounting Principles ("GAAP") to correct misstatements in financial statements ***based on information known at the time the financial statements were originally filed*** and to correct misapplications of GAAP. ¶¶142-43 (citing Accounting Principles Board Opinion ("APB") No. 20, ¶¶7-13, 31), 147. The restatement was an admission that the financial results, all contemporaneously audited by Andersen, were ***false when reported*** based on knowledge available at the time. ¶¶142-43, 147, 174-75.

Andersen's submission that the restatement should not be considered because it is inadmissible as a subsequent remedial measure is wrong and premature. Evidence of remedial measures is admissible for reasons other than to show culpable conduct, including knowledge and prior notice. *Farmington Casualty Co. v. 23rd Street Properties Corp.*, 98 Civ. 3597(HB)(KNF), 1998 U.S. Dist. LEXIS 17077, at *3 (S.D.N.Y. Oct. 27, 1998). Moreover, admissibility at trial due to disputes of fact will not be decided on a motion to dismiss. *Wright Tree Service v. Commonwealth Edison Co.*, Case No. 00 C 2482, 2000 U.S. Dist. LEXIS 12622, at *6 (N.D. Ill. Aug. 23, 2000).

A restatement can support scienter against an auditor. *MicroStrategy*, 115 F. Supp. 2d at 651 (the magnitude and pervasiveness of the financial restatement and the relative simplicity of the accounting principles violated lend probative weight to plaintiffs' allegations that the GAAP violations raise a strong inference of scienter). Here, plaintiffs allege that the restatement was so large and pervasive that without the improper accounting manipulations, Household would not have been able to post back-to-back record-breaking quarters or exceed analysts' expectations throughout the Class Period. ¶¶25, 27, 140, 162-163. Andersen was Household's auditor for 17 years and had audited every annual financial statement during the Class Period. *See* Ex. A attached hereto at F-1; ¶¶174-75. Yet KPMG, LLP ("KPMG"), only a few months after it replaced Andersen and in the middle of a fiscal year, made Household restate its financial statements all the way back to 1994. ¶¶5, 135, 151. Like KPMG, Andersen had access to facts showing that Household's inappropriate amortization periods violated GAAP – and had been doing so for years. ¶¶46, 135, 171; Consent Decree (RJN, Ex. 2).

Plaintiffs allege additional facts that raise a strong inference of Andersen's scienter. For example, in 1993, at Andersen's direction, Household continued to use amortization periods for its co-branding agreement in a manner that violated GAAP. ¶¶138(a), 148; Ex. B attached hereto at 2. Andersen had specific discussions with Household regarding this issue and together they made the decision relating to this accounting issue. Ex. B attached hereto at 2. The senior person at Andersen who consulted with Household regarding this accounting decision, was the same person who actually wrote the Emerging Issues Task Force Release Issue No. 93-1, which set out the correct amortization period. *Id.* Furthermore, Andersen knew that, in 1999, Household arbitrarily increased the

amortization period for premiums paid pursuant to its affinity agreement by 50%. ¶¶138(b), 150. This was a "red flag" because Andersen also knew that Household did not change these amortization periods for regulatory reporting purposes. *Id.*

Andersen argues that the restatement is based on "relatively straightforward accounting discrepancies" which KPMG merely "recommended" be revised. Andersen Def's Mem. at 1, 3-4, 9 n.5. But, defendant's fact-bound defense is not properly considered at this stage, where plaintiffs' allegations must be accepted as true. *In re Accelr8 Tech. Corp. Sec. Litig.*, 147 F. Supp. 2d 1049, 1055-56 (D. Colo. 2001).

Indeed, while GAAP tolerates a range of reasonable treatments, an application of GAAP that strays beyond the boundaries of reasonableness – as plaintiffs allege this one did – provides an inference of scienter. *In re Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 148 (D. Mass. 2001). Thus, the Complaint alleges both falsity and scienter. Andersen's statement that it does not agree that the financial statements contained any errors is gratuitous, and in any event, improper at this stage.

C. The Complaint Identifies Specific, Highly Suspicious Facts Known or Recklessly Ignored by Andersen

Andersen asserts that 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.'" Andersen Def's Mem. at 6 (quoting *In re SmarTalk Teleservices, Inc. Sec. Litig.*, 124 F. Supp. 2d 505, 515 (S.D. Ohio 2000)). Plaintiffs have done exactly that. Therefore, the motion to dismiss should be denied.

1. Andersen Knew or Recklessly Disregarded Highly Suspicious "Red Flags" Regarding the Reaging

Andersen knew or recklessly disregarded highly suspicious facts regarding reaging. As mentioned above, the large discrepancy between the reported delinquency rate (half the rate of Household's peers') and the true delinquency rates, detectable through a sampling, was a highly suspicious fact. ¶¶14, 123-24, 127-28, 174. Once KPMG was hired by Household as its auditor, KPMG within a few weeks caused Household to disclose reaging statistics – a crucial measure of Household's credit quality. ¶¶123, 323. These reaging statistics revealed that 17% of Household's domestic portfolio, 20% of its real estate loans and over 27% of its "personal non-credit card" loans had been reaged; a huge number of accounts had been reaged multiple times. ¶¶123, 127.

Household later entered into an SEC Consent Decree which imposed a cease-and-desist order on Household and declared Household in violation of §10(b) and Rule 10b-5 for making false and misleading statements relating to its reaging practices. RJN, Ex. 2. The Consent Decree made specific findings that a) Household was and knew that it was ***outside of the range of its peer group*** with respect to automatically restructuring delinquent accounts, b) more than ***$1 billion*** in loans were restructured ***per month***, the majority of which were restructured automatically, and b) 53.9% of real

estate secured loans and 75.2% of personal homeowner loans that had been restructured were either restructured again, delinquent or charged off. *See id.*, ¶¶9-11.

Additionally, Andersen knew of or recklessly disregarded a number of other highly suspicious facts. In spite of a general economic down-turn and even though Household's competitors, such as Associates First Capital and ContiFinancial were experiencing tremendous financial difficulties and were struggling to survive, Household reported dramatic growth and record earnings quarter after quarter throughout the Class Period. ¶¶25, 192, 197, 204, 209, 214, 218, 229, 233, 237, 243, 252, 258, 263, 272, 285, 289, 298, 311, 324, 333. At the same time, Household's executives, whose compensation was tied to Household's performance, were receiving multi-million dollar bonuses from hitting a series of stock-price targets, receivable growth targets and other performance targets. ¶¶156-63, 183. The fact that a significant portion of management's compensation was contingent upon achieving unduly aggressive targets, as well as management's resulting "excessive interest" in increasing Household's stock price, are specific fraud risk factors, delineated in the Statement of Auditing Standards ("SAS") No. 82 (AU §§316.16-.18). ¶¶182-83.[6] Andersen knew of these facts signaling a high risk of fraud, but chose to ignore them. ¶¶182-83. Also, in a footnote to its Form 10-K for 2000, which Andersen audited, Household revealed that, in 1999, it had shifted $6.7 billion in credit card receivables from its banking unit to its subsidiary. ¶¶171, 174-75, 250. The Complaint alleges that this was done to avoid new regulations stiffening credit charge-off and delinquency reporting requirements. ¶250. These specific, highly suspicious facts which Andersen ignored either deliberately or recklessly – in combination – meet plaintiffs' pleading requirement.

2. Andersen Knew or Recklessly Disregarded Highly Suspicious "Red Flags" Regarding the Predatory Lending

In addition to the suspicious provisions in the loan agreements which Andersen should have detected during the test examinations they claimed to have conducted, ¶174, there were other highly suspicious circumstances indicating fraud that Andersen knew about or recklessly ignored.

In 2001, Household had to repeatedly publicly defend itself from charges of predatory lending. ¶¶280, 300-301. On 7/23/01, Household announced that it would implement new responsible lending initiatives and redefine "best practices" even though Household had earlier maintained that it already had stringent policies and procedures in place. ¶¶266, 293. A day later, Household declared that the timing of these new policies was not tied to actions by fair-lending advocates. ¶294. In 11/01, the California Department of Corporations filed a lawsuit against

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[6]These specific Generally Accepted Auditing Standards ("GAAS") fraud risk factors are ***not*** the only "red flags" alleged in the Complaint as demonstrated by the abundance of highly suspicious "red flags" laid out in §§III.B-C, *supra*. Furthermore, contrary to Andersen's claims, these specific GAAS fraud risk factors alleged in the Complaint are recognized "red flags." *Enron*, 235 F. Supp. 2d at 677-79.

Household for over billing its customers. ¶300. Then, in 1/02, Household settled this suit for $12 million – ***three-quarters of which was for penalties***. ¶19. A month later, a nationwide class action lawsuit was filed accusing Household of fraud in procuring over $2 billion in loan originations secured by customers' homes and automobiles. ¶317. In 2/02, Household again repeatedly and publicly denied charges that it had engaged in predatory lending. ¶¶317, 320.

Household engaged in a pervasive and nationwide pattern of predatory lending. Pltfs' Household Resp., §II.A. Household ultimately had to agree to various settlements, including ***the largest settlement ever in a state or federal consumer case*** with ***the state attorney generals of all 50 states and the District of Columbia***, resulting in a $525 million charge against earnings. ¶¶5, 23, 97-99, 344. Even investigations by outside regulatory agencies without the benefit of access to the Company established that predatory lending was ingrained in Household's "corporate culture." ¶¶18, 23, 74, 93.

Nonetheless, despite the array of warning signs, when Household filed its 2001 Report on Form 10-K incorporating Andersen's clean audit opinion dated 1/14/02, Andersen did not qualify, withdraw or disclaim its opinion. ¶¶174, 313, 316. Even where the auditor does not have scienter at first, when the auditor subsequently learns of fraudulent conduct, it must correct its audit reports. *Wafra Leasing Corp. 1999-A-1 v. Prime Capital Corp.*, No. 01 C 4314, 2002 U.S. Dist. LEXIS 22838, at **27-28 (N.D. Ill. Nov. 25, 2002). Again, plaintiffs' specific allegations of highly suspicious facts are sufficient to state a claim against Andersen.

D. The Complaint Alleges Both Falsity and Scienter as to Andersen

Because falsity and scienter are generally strongly inferred from the same set of facts, plaintiffs combine the discussion of falsity with that of scienter. *Ronconi v. Larkin*, 253 F.3d 423 (9th Cir. 2001).

Andersen urges the Court to view plaintiffs' allegations piecemeal, as if each allegation itself must raise a strong inference. Courts reject this approach. *In re Cabletron Systems*, 311 F.3d 11, 39 (1st Cir. 2002) (plaintiff may combine various facts and circumstances indicating fraudulent intent, including those demonstrating motive and opportunity, to satisfy the scienter requirement); *Lipton v. PathoGenesis Corp.*, 284 F.3d 1027, 1038 (9th Cir. 2002) (court considered whether the total of plaintiffs' allegations, even though individually lacking, were sufficient to create a strong inference of defendants' scienter); *Riggs Partners, LLC v. Hub Group, Inc.*, No. 02 C 1188, 2002 U.S. Dist. LEXIS 20649, at *14 (N.D. Ill. Oct. 25, 2002) (a court should not consider each relevant factual allegation solely in isolation but rather, as a part of the overall factual picture painted by the complaint); *In re First Merchants Acceptance Corp. Sec. Litig.*, Master File No. 97 C 2715, 1998 U.S. Dist. LEXIS 17760, at **32-33 (N.D. Ill. Nov. 2, 1998) (the magnitude of the misstatements, the specific GAAP and GAAS violations and the "red flags" together support an inference that the audit amounted to no audit at all or an egregious refusal to see the obvious or investigate the doubtful).

When plaintiffs' allegations are considered in their totality, the inference of scienter is overwhelming. Contrary to Andersen's repeated mischaracterization, this is not "just a GAAP violation case." Andersen Def's Mem. at 3, 8-9. The court in *In re American Bank Note Holographics Sec. Litig.*, 93 F. Supp. 2d 424, 447 (S.D.N.Y. 2000), held that plaintiffs had alleged more than mere GAAP violations where the admitted falsity of the statements, the extraordinary degree to which they were false, the length of time (covering several years) that the statements were false, and defendants' access to the actual information, combined raised a strong inference that defendants engaged in conduct that was either conscious or reckless. *Id.* As in *American Bank Note,* plaintiffs here allege an admitted falsity (the restatement), that Household would not have met or exceeded analysts' expectations absent the fraud, that the fraudulent scheme went on throughout the Class Period, and that Andersen had continual access to Household's information and personnel.

Furthermore, in addition to the numerous GAAP and GAAS violations, the Complaint identifies abundant "red flags," as well as Andersen's motive and opportunity to participate in or ignore the fraud, which all combine to raise a strong inference of Andersen's scienter.

1. Andersen Made False and Misleading Representations When It Represented that Household's Financials Were Prepared in Conformance with GAAP and GAAS

Plaintiffs' allegations that the GAAP violations resulted in material misstatements in the financials, and that the auditor failed to follow proper auditing procedures, combined with allegations of the auditor's deliberate or reckless ignorance of numerous "red flags" are adequate to suggest that the auditor turned a blind eye to the company's fraudulent activities, thus creating a "strong inference" of the auditor's recklessness. *In re Health Management, Inc. Sec. Litig.*, 970 F. Supp. 192, 203 (E.D.N.Y. 1997); *see also Danis v. USN Communications, Inc.*, 73 F. Supp. 2d 923, 941-42 (N.D. Ill. 1999).

Andersen represented that Household's financial statements for 1997 through 2001 fairly presented, in all material respects, the financial position of Household, that they were presented in accordance with GAAP, and that Andersen's audits of them had been performed in accordance with GAAS. ¶¶173-75, 202, 227, 249, 279, 316. The Complaint alleges that these representations were false because the financial statements misrepresented Household's true earnings by overstating its income, reporting lower than required credit loss reserves and misstating certain of Household's expenses due to improper amortization periods, each of which resulted in an overstatement of net income throughout the Class Period. ¶¶14, 125, 128-29, 137-38, 196, 217, 242, 271, 302, 307, 342. Moreover, the financial statements were false and violated GAAP and SEC regulations because they failed to disclose the pervasive abusive lending and arbitrary reaging practices, and failed to take appropriate reserves to cover these loss contingencies. ¶¶102, 104-106, 129, 130-33. These non-disclosures severely impacted Household's financial results and masked the true risk of investing in Household's securities. ¶¶5, 14, 22-24, 97, 102, 106, 128, 130-33.

Andersen conducted a deficient audit and severely departed from GAAS. ¶¶182-91. Where the auditor is aware of highly suspicious facts, the auditor's failure to investigate further can raise a strong inference that the audit was so deficient that it amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful. *See In re Complete Management Sec. Litig.*, 153 F. Supp. 2d 314, 333-34 (S.D.N.Y. 2001). In the face of many warning signs, the auditor is required by GAAS to conduct a more substantive audit rather than to accept the company's unsupported explanations of the numbers in its financial statements. *Great Neck Capital Appreciation Investment Partnership, L.L.P. v. PricewaterhouseCoopers, L.L.P.*, 137 F. Supp. 2d 1114, 1123 (E.D. Wis. 2001). Plaintiffs plead with specificity abundant "red flags," including specific fraud risk factors delineated in SAS No. 82 (AU §316.16-.18), which Household possessed and which Andersen should have considered in an audit. *See* §§III.B-C, *supra*; ¶¶182-83.

Yet, despite the numerous "red flags" listed above, Andersen, in violation of GAAS, failed to make the investigation required of an independent auditor to obtain "sufficient competent evidential matter" to determine the accuracy of the financial statements. *See, e.g., First Merchants,* 1998 U.S. Dist. LEXIS 17760, at *15 (GAAS provides that an inability to obtain sufficient competent evidential matter requires an auditor to qualify or disclaim an opinion). Specifically, Andersen failed, *inter alia,* to (a) assess the risk of material misstatements due to fraud, (b) plan and perform the audit to obtain reasonable assurance about whether the financial statements were free of material misstatements, (c) consider whether Household's disclosures were adequate, (d) consider the effect of any illegal act, (e) obtain sufficient competent evidential matter to support Household's assertions regarding its income, assets, debt and shareholders' equity, and (f) consider whether Household's disclosures accompanying its financial statements were adequate. ¶¶182-83, 185, 187, 190. *See Enron,* 235 F. Supp. 2d at 686 (Andersen had the responsibility as Enron Corp.'s independent auditor, but failed, to gather "sufficient competent evidential matter ... to afford a reasonable basis for an opinion regarding the financial statements under audit"). In fact, Andersen's "clean" audit reports violated GAAS and SEC rules because Household's financial statements were false and misleading in violation of GAAP themselves. ¶¶173, 176.

Where plaintiffs allege that the auditor had knowledge of the company's internal workings and had a history with the company, failures to observe GAAS amount to a level of recklessness high enough to maintain an action under §10(b). *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1346 (S.D. Fla. 1999); *Jacobs v. Coopers & Lybrand, L.L.P.*, 97 Civ. 3374 (RPP), 1999 U.S. Dist. LEXIS 2102, at *40 (S.D.N.Y. Mar. 1, 1999) (auditor's motion to dismiss was denied because trier of fact ***could*** find auditor's audit so reckless that it should have had knowledge of the underlying fraud). Here, Andersen had a long history with Household and its failure to consider the risk factors and other warning signs in its audit amounted, at a minimum, to severe recklessness. These allegations, viewed in the light most favorable to plaintiffs at this stage, state a claim for fraud against Andersen.

2. Andersen Knew or Was Extremely Reckless in Ignoring Highly Suspicious "Red Flags"

Allegations of obvious "red flags" or warning signs that financial reports are misstated, as well as the magnitude of the fraud alleged, can give rise to a strong inference of fraudulent intent. *Chu v. Sabratek Corp.*, 100 F. Supp. 2d 815, 824 (N.D. Ill. 1999); *First Merchants*, 1998 U.S. Dist. LEXIS 17760, at **30-31. Deliberately ignoring "red flags" can constitute the sort of recklessness required for scienter. *Great Neck Capital Appreciation,* 137 F. Supp. 2d 1114.

As discussed in §II.C, *supra*, the Complaint pleads abundant "red flags" and highly suspicious facts that Andersen knew or was extremely reckless in not knowing that the financial reports were false. Andersen claimed to have examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements. ¶¶174-75. An examination would have shown any of the following red flags: (a) the high percentage of reaged loans (20% of real estate loans, almost 17% of total domestic portfolio, over 27% of "personal non-credit card" loans), ¶¶123, 127; (b) a vast number of accounts that had been reaged multiple times or were severely delinquent or charged-off after having been reaged (53.9% of real estate secured loans, 75.2% of personal homeowner loans), ¶¶118, 123; Consent Decree, ¶10 (RJN, Ex. 2); (c) 7 to 8 points added in the loan amount without a corresponding buy-down of the interest rate, ¶¶61-64; (d) an unusually large percentage of real estate loans carrying insurance, ¶¶72-73; (e) loans with 100%-125% loan-to-value ratios, ¶¶77-78; and (f) secondary loans with interest rates of 20% or higher at the time of funding of the first mortgage loan. ¶¶51, 75, 77.

Moreover, as Household's long-term consultant, Andersen knew that Household's customer base was primarily composed of subprime consumers with modest incomes, high debt-to-income ratios or previous credit problems, that Household not only generated high risk loans but also sold them as asset-backed securities, and that it was critical to Household's profitability that its loan pools were stable and consistent. ¶¶11, 12, 107-109. Andersen knew that there was an attendant high risk of delinquencies and defaults in the subprime lending industry and that delinquency rate and restructuring statistics were key measures of performance, which investors and analysts used to evaluate Household's credit quality. ¶¶4, 12, 14, 24, 107, 109, 222. Yet, despite that knowledge, Andersen ignored highly suspicious facts, such as reported record growth during a time when other subprime lenders were struggling to survive, management's receipt of enormous bonuses based on the reported growth, and Household's strategic shift of $6.7 billion in credit card receivables to avoid harsher delinquency reporting requirements.

Andersen also ignored that Household was repeatedly being accused of predatory lending practices and had to defend itself publicly. Two lawsuits were filed against Household. ¶¶300, 317. These lawsuits alone should have put Andersen on high alert. One of the lawsuits was settled for significant penalties. ¶¶19, 300. The other alleged a nationwide pattern and abusive lending practices. ¶317. Yet, despite these obvious "red flags" indicating that Household engaged in illegal

lending practices, Andersen, without making any inquiries into the possible truth of the charges, issued a clean audit opinion for fiscal year 2001. ¶¶175, 316.

The magnitude and the pervasiveness of the fraud in this case support a strong inference of scienter. *See, e.g., First Merchants,* 1998 U.S. Dist. LEXIS 17760, at **32-33; *In re Livent Sec. Litig.*, 148 F. Supp. 2d 331, 367-68 (S.D.N.Y. 2001). Not only did Household have to take charges and write-offs of over $1 billion in third quarter 2002, but its agreement to refrain from further illegal activities caused Fitch to place Household on Rating Watch Negative. Without being able to continue its illegal activities, Household had lost its competitive advantage. ¶¶6, 100, 344.

Andersen's contention that there are no specific allegations of which Andersen personnel were present, which of the corporate documents were allegedly seen or what corporate information allegedly was known by Andersen, is without merit. The specifics of Andersen's audit are precisely the type of facts particularly within defendants' knowledge and need not be pled. *First Merchants,* 1998 U.S. Dist. LEXIS 17760, at *33 n.5; *Chu*, 100 F. Supp. 2d at 821-22 (plaintiffs need not allege every single detail in the complaint). Where there has been no discovery courts will not dismiss complaints even when some questions remain unanswered, so long as the complaint as a whole states a claim. *Cabletron Systems*, 311 F.3d at 32-33.

Lastly, to characterize Household's failure to restate its financial statements with respect to the predatory lending and reaging practices as KPMG's "concurrence" with Andersen's treatment is preposterous. Andersen Def's Mem. at 2. KPMG replaced Andersen as Household's auditor in 3/02. Shortly after that, on 4/09/02, KPMG made Household break out its reaging statistics for the first time. ¶¶123, 323. Thus, KPMG did not "concur" with Andersen's previous treatment of the topic, which was to conceal these practices. KPMG also required Household to restate its financial statements with respect to the accounting for its credit card agreements for the past eight years. Finally, in the first financial statement on which KPMG opined, it made the Company take a $525 million charge for Household's settlement relating to its predatory lending practices. This hardly shows "concurrence" with Andersen's practices. *Cf. Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 83 (1st Cir. 2002) (absence of a restatement does not undermine sufficiently pled allegations of falsity and scienter).

In re IKON Office Solutions, Inc., 277 F.3d 658 (3d Cir. 2002), does not support Andersen's proposition. KPMG was not hired to review Andersen's work, opine on Andersen's work or point out Andersen's violation of GAAS. *Id.* at 664, 669. KPMG replaced Andersen as Household's new auditor after Andersen's history of accounting improprieties caught up with it. ¶¶180-81.

3. Andersen Had Powerful Economic Motives to Commit Fraud

Where the Complaint alleges that the auditor provides considerable consulting services, it is reasonable to infer that the auditor's desire to maintain the considerable revenue created incentives to please management at the expense of accuracy and/or completeness. *Complete Management,* 153 F. Supp. 2d at 335 ($1 million in consulting fees supported inference of scienter).

Andersen contends that plaintiffs did not allege that the fees earned were extraordinary in size or were tied into more lucrative consulting services. Andersen Def's Mem. at 7. But, the Complaint alleges precisely these facts. ¶¶46, 171, 177-78. It specifically alleges that Andersen not only audited Household's financial statements, but also provided consulting services on a wide range of topics throughout the Class Period. ¶171. Andersen's audit partners' compensation was tied to the solicitation and marketing of consulting services. ¶178. In 2000 and 2001 alone, Andersen earned $3.9 million in auditing fees and $4.7 million in non-auditing fees. ¶177. It is reasonable to infer that Andersen had earned similarly large fees from Household in prior years.

In *Complete Management*, the court held that Andersen's desire to maintain the revenue of ***$1 million*** in consulting fees supported an inference of scienter. 153 F. Supp. 2d at 335. The court noted that rules proposed by the SEC to curb such "dual relationships" demonstrate "the manifest opportunities for fraud" inherent in these relationships. *Id.* The fees earned by Andersen from Household were significantly higher than those earned by it in *Complete Management*. In any event, the amount of fees and the resulting extent of Andersen's motive are factual questions that are not properly resolved at this stage.

Andersen argues a plaintiff must "overcome irrational inference that the accountant would risk its professional reputation to participate in the fraud of a single client." *Reiger v. Price Waterhouse Coopers LLP*, 117 F. Supp. 2d 1003 (S.D. Cal. 2000).[7] Andersen is wrong. First, Andersen did not simply participate in the fraud "of a single client," it considered compromising its integrity and getting caught allying itself with management's interest to be an ordinary and necessary cost of doing business. ¶¶180-81. Second, *Reiger* itself qualified its holding by stating "a large independent accountant will ***rarely***, if ever, have any rational economic incentive to participate in its client's fraud." *Reiger*, 117 F. Supp. 2d at 1007. Here, plaintiffs allege Andersen's calculated cost/benefit approach to ignoring fraud ¶¶177, 181. Third, *Reiger* quotes and relies on *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990). However, as Judge Easterbrook, the author of *DiLeo* himself later held, an auditor's "hope of enlarging the stream of revenues in future years" can indeed raise an inference of scienter. *Frymire-Brinati v. KPMG Peat Marwick*, 2 F.3d 183, 191 (7th Cir. 1993). In any event, the extent of Andersen's motive is a question for trial; sufficient facts have been alleged to state a claim.

E. Plaintiffs Have Adequately Pled Loss Causation

The fact that Household's share price closed higher on the day of the restatement does not absolve Andersen. In *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920 (9th Cir. 2003), the court rejected a bright-line rule requiring an immediate market reaction. *Id.* at 934. In *America West*, the company's disclosures of a settlement agreement had no immediate effect on the market price, but the stock price dropped 31% when the

[7]The other cases cited by Andersen do not add any pertinent argument.

full economic effects of the settlement agreement and the ongoing maintenance problems were finally disclosed to the market. *Id.* at 935. Significantly, the court recognized plaintiffs' reason for the delay in the stock drop, namely, that the company continued to reassure analysts that the settlement agreement would not have a noticeable economic effects. *Id. See also Tracinda Corp. v. DaimlerChrysler AG,* 197 F. Supp. 2d 42, 66-68 (D. Del. 2002) (plaintiffs adequately pled loss causation where stock price rose briefly after defendant's admission but ultimately fell once the complete nature of defendants' scheme was revealed).

Similarly, plaintiffs here have alleged that Household continued to reassure analysts that the restatement would not have noticeable economic effect on the Company. Household's press release was issued before the markets opened for trading. ¶140. In it, defendant William Aldinger stated: "'These changes are not expected to have any significant impact on our future results of operations.... The restatement ... is small relative to the results we have reported over the period 1993 through 2001....'" *See* Ex. B filed in support of the Household defendants' motion to dismiss; Andersen Def's Mem. at 1-2. Defendants Aldinger and David Schoenholz reiterated this in a conference call to analysts that same day. ¶337. As in *America West,* Household's continued misrepresentations had the effect of delaying the drop in market price until the full economic effect of the fraud – including Household's pervasive abusive lending and arbitrary reaging practices – was revealed. ¶140.

In addition, the Complaint alleged that there was ***some*** reaction to the restatement. When the market opened that day, the shares immediately suffered a decline of over $4.71 per share relative to the prior day's close. *Id.* However, due to Household's efforts to bolster the stock price, it stabilized before closing slightly higher on that day. *Id.* The reasonable inference is that ***some*** investors reacted negatively to the announcement of the restatement; yet, due to Household's great efforts, the full economic effect of the fraudulent scheme was not yet disclosed to the market. The market responded when more of the truth was revealed: Household amended its fiscal 2001 Report on Form 10-K incorporating the restatement, rumors of the impending settlement came out, and finally, Household broke out its massive reaged statistics. ¶¶101, 141, 344.

Andersen attempts to parse the fraudulent scheme and places the blame for the stock decline on the predatory lending practices, reaging of delinquent accounts and other Household misrepresentations. Andersen Def's Mem. at 12. As established above, plaintiffs plead sufficient facts to show that Andersen was either knowingly part of the massive fraud or recklessly disregarded it. Andersen's false representations in the financial statements contributed to the artificial inflation of the stock. Moreover, which specific events or combination of events ultimately caused the loss is a fact-intensive matter requiring expert testimony concerning the state of the financial markets and the like and, therefore, is inappropriate for disposition in the context of a motion to dismiss. *Tracinda,* 197 F. Supp. 2d at 67-68; *see also Semerenko v. Cendant Corp.,* 223 F.3d 165, 187 (3d Cir. 2000) (at the pleading stage, a complaint alleges sufficient facts to establish the element of loss

causation where a reasonable inference can be drawn that the misrepresentation caused the inflation of the stock price, despite other possible inferences).

Lastly, loss causation is sufficiently pled where plaintiffs allege that the undisclosed scheme caused the market price of the company's stock purchased by class members to be higher than it would have been if the true facts were known. *Semerenko,* 223 F.3d at 184. The requirement to plead loss causation "ought not place unrealistic burdens on the plaintiff at the initial pleading stage." *Tatz v. Nanophase Tech. Corp.,* No. 01 C 8440, 2002 U.S. Dist. LEXIS 19467 (N.D. Ill. Oct. 9, 2002) (loss causation adequately pled where plaintiff bought stock at artificially inflated prices as a direct result of defendants' statements). Plaintiffs adequately plead loss causation by alleging that, due to defendants' misrepresentations, plaintiffs purchased stock at artificially inflated prices and were thereby damaged. ¶¶24, 28, 36, 50, 102-106, 125-33, 137-39, 174-75.

Andersen's argument, in a footnote, that plaintiffs must plead loss causation for their §11 claim is plainly wrong. Andersen Def's Mem. at 12 n.9. Under §11, a plaintiff does not have to prove reliance, causation or scienter. *Alpern v. UtiliCorpUnited,* 84 F.3d 1525, 1541 (8th Cir. 1996).

F. Plaintiffs Brought This Action Within the Applicable Statute of Limitations

The Complaint was filed within the applicable statute of limitations, as established by the Sarbanes-Oxley Act. 28 U.S.C. §1658(b)(2). Therefore, Counts III and IV are not time barred. Because this discussion applies equally to all defendants and has been raised in all three motions to dismiss, plaintiffs discuss the applicable statute of limitations in detail in their response to the Household defendants' motion to dismiss, a copy of which will be served on all defendants, including Andersen. *See* Pltfs' Household Resp., §IV.E.2. That argument is fully incorporated in this brief.

IV. CONCLUSION

For the above reasons, Andersen's motion to dismiss should be denied in full.

V. REQUEST FOR LEAVE TO AMEND

In the event that this Court grants any part of Andersen's motion, plaintiffs respectfully request leave to amend. It is well settled that leave to amend should be "freely given when justice so requires." Fed. R. Civ. P. 15(a); *see Ferguson v. Roberts,* 11 F.3d 696, 706 (7th Cir. 1993) ("leave to amend should be granted under Federal Rule of Civil Procedure 15(a) unless there is 'undue delay, bad faith or dilatory motive on the part of the movant, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of

allowance of the amendment, [or] futility of amendment'") (quoting *Foman v. Davis*, 371 U.S. 178, 182 (1962)).

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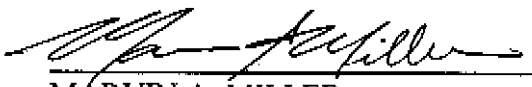
Respectfully submitted,



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See Case File for Exhibits