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.	)	

NOTICE OF FILING

TO: Counsel on Attached Service List

PLEASE TAKE NOTICE that on **August 1, 2003**, Defendant Arthur Andersen LLP, by and through its attorneys, Mayer, Brown, Rowe & Maw LLP, caused to be filed with the United States District Court for the Northern District of Illinois, **Defendant Arthur Andersen LLP's Corrected Reply Memorandum in Support of its Motion to Dismiss Counts I, III and IV of Plaintiffs' [Corrected] Amended Consolidated Complaint**, copies of which are attached and hereby served upon you.

Respectfully submitted,

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

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INTRODUCTION

Plaintiffs' [Corrected] Amended Consolidated Complaint weighs in at 154 pages, and nearly 400 paragraphs, but few of the allegations in that mountain of verbiage even mention defendant Arthur Andersen, Household's former outside auditor. Paragraphs 171-91 of the complaint purport to set forth "Andersen's Role in Defendants' Fraudulent Scheme and Unlawful Course of Conduct." In its opening brief, Andersen reviewed those paragraphs and explained why they fail to meet the PSLRA's stringent requirements for alleging securities fraud. In particular, Andersen showed that Plaintiffs' technique of simply listing various GAAP and GAAS provisions and then alleging in conclusory and boilerplate terms that Andersen's audits violated those provisions, without providing any supporting factual detail, is wholly inadequate to satisfy the PSLRA's requirement that a complaint state "*with particularity facts* giving rise to a *strong* inference" that the defendant acted with intent to deceive, or be dismissed. *See* 15 U.S.C. §78u-4(b)(2), (3) (emphasis added). In their response brief, Plaintiffs ignore most of Andersen's arguments, and simply repeat, again and again, the conclusory allegations of their complaint.

Plaintiffs concede, as they must, that mere allegations of accounting mistakes, whether GAAP or GAAS violations, are insufficient to state a claim for securities fraud, but Plaintiffs offer nothing more than a rehash of their conclusory assertions of GAAP and GAAS violations. Plaintiffs concede, as they must, that to state a claim of securities *fraud* – rather than mere negligence – against an outside auditor, they must allege facts showing that the audit was so deficient that it "amounted to no audit at all," or that the accounting judgments "were such that no reasonable accountant would have made the same decisions if confronted with the same facts." Yet Plaintiffs have failed to allege any facts indicating that *any* other accountant (much less *every* reasonable accountant) would have disagreed with Andersen's professional judgments

regarding most of the items at issue in the complaint. Nor could Plaintiffs make such allegations, given that Household's successor auditor, KPMG, *concurred* with Andersen's conclusions regarding all but one accounting issue (regarding amortization periods) that had only a small effect on Household's financial statements, and the restatement of which did not even cause Household's stock to go down. A head in the sand is no substitute for a reasoned argument, and ignoring the requirements of the PSLRA will not make them go away. As Andersen showed in its opening brief, and demonstrates further below, the PSLRA requires that Plaintiffs' 10b-5 claim against Andersen be dismissed.

Andersen also showed in its opening brief that the complaint fails to allege loss causation against Andersen, and actually refutes such a theory by conceding that the value of Household's stock *increased* on the day of the restatement. Plaintiffs respond by arguing that *Household's* "continued misrepresentations" regarding alleged predatory lending practices and reaging of delinquent accounts artificially inflated the stock price and prevented a market drop in response to announcement of the accounting restatement. Pl. Br. 13. Such an argument merely concedes that Plaintiffs were not harmed by any purported misrepresentation by *Andersen*.

Finally, Andersen showed in its opening brief that Plaintiffs' claims under Section 11 of the 1933 Act are barred by the three-year statute of repose that applies to Section 11 claims by virtue of Section 13 of the 1933 Act. Plaintiffs concede that they filed suit after expiration of the three-year limitations period, but argue that the limitations period for Section 11 claims was extended to five years by the Sarbanes-Oxley Act. This argument has been rejected by every court to have considered it, and for good reason. By its clear terms, Sarbanes-Oxley extended the limitations period only for securities fraud suits, and not for Section 11 claims which do not require a showing of fraud.

ARGUMENT

I. PLAINTIFFS FAIL TO REFUTE ANDERSEN'S SHOWING THAT COUNT I OF THE COMPLAINT MUST BE DISMISSED FOR FAILURE TO ALLEGE FACTS RAISING A STRONG INFERENCE THAT ANDERSEN ACTED WITH SCIENTER.

A. Plaintiffs Misstate The Standard of Review.

As a threshold matter, Plaintiffs misstate the standard this Court must apply in assessing Andersen's motion to dismiss. Since enactment of the PSLRA, it is no longer true that the court must "draw all reasonable inferences in favor of the plaintiffs" and can dismiss only where plaintiffs can prove "no set of facts" to support their claim. *See* Pl. Br. 3. The PSLRA's requirement that a complaint be dismissed unless it states "with particularity facts giving rise to a *strong* inference" that the defendant acted with scienter (15 U.S.C. §78u-4(b)(2) (emphasis added) "obliterates notice pleading in private securities fraud cases and, by implication, the liberal standards typically used to decide motions to dismiss." *Chu v Sabratek Corp.*, 100 F. Supp. 2d 827, 837 (N.D. Ill. 2000). The PSLRA "strengthened the minimum showing necessary to survive a motion to dismiss," so that "plaintiffs are entitled only to the most plausible of competing inferences," those inferences that are so "reasonable and strong" that they "leave little room for doubt as to misconduct." *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550, 553 (6th Cir. 2001) (en banc), *cert. dismissed*, 536 U.S. 935 (2002).

"It is not enough * * * to state facts giving rise to a mere speculative inference of [scienter], or even a reasonable inference of [scienter]." *In re Silicon Graphics Ins. Sec. Litig.*, 183 F.3d 970, 985 (9th Cir. 1999). If the "facts alleged do not exclude other plausible explanations that would undercut a plaintiff's circumstantial inference of scienter, then the plaintiff's facts cannot be fairly said to raise a 'strong inference' that the defendant acted with the

required state of mind." *Sakhrani v. Brightpoint, Inc.*, 2001 WL 395752, at *22 (S.D. Ind. Mar. 29, 2001) (attached as Exhibit 1). As Andersen showed in its opening brief and shows further below, Plaintiffs' allegations against Andersen fall far short of this rigorous standard.

B. Plaintiffs' Conclusory Allegations That Andersen Had Access To Unspecified Information Do Not Satisfy the Scienter Pleading Standard.

Plaintiffs argue that scienter can be inferred because Andersen had been Household's auditor since 1985, prepared Household's tax returns, and provided consulting services "on a wide range of topics." Pl. Br. 1-2. Yet the complaint fails to allege any *facts* that Andersen learned in its work for Household over those years (whether auditing or consulting) that supposedly led Andersen to know of or recklessly disregard any material error in Household's audited financial statements. *See Danis v. USN Communications*, 121 F. Supp. 2d 1183, 1194 (N.D. Ill. 2000) (rejecting argument that because Deloitte & Touche did consulting work for the company regarding operational system problems, the Deloitte auditors must have learned of errors in the company's financial statements).

Plaintiffs also argue that scienter can be inferred because unnamed Andersen personnel were present at Household's offices "throughout the year" and had "continual access to [unspecified] corporate, financial and business information." Pl. Br. 2. Such vague and conclusory allegations are patently insufficient to raise an inference of scienter. To satisfy the pleading standard, a complaint must "specifically identify the internal reports" or other nonpublic information that was known to a securities fraud defendant and that makes the defendant's public statements false, including "names and dates." *San Leandro Emergency Med. Group v. Philip Morris*, 75 F.3d 801, 812-13 (2d Cir. 1996). *Accord Abrams v. Baker Hughes, Inc.*, 292 F. 3d 424, 432 (5th Cir. 2002) ("An unsupported general claim about the existence of confidential corporate reports that reveal information contrary to reported accounts is insufficient

to survive a motion to dismiss. Such allegations must have corroborating details regarding the contents of the allegedly contrary reports, their authors and recipients."). As the Seventh Circuit stated in *Arazie v. Mullane*, 2 F.3d 1456, 1467 (7th Cir. 1993), allegations regarding "unreleased or internal information that allegedly contradict[s defendants'] public statements" should specify "who prepared the projected figures, when they were prepared, how firm the numbers were, or which * * * officers reviewed them."

Such specificity is necessary because *all* auditors and high ranking corporate officers spend time at company offices and have access to confidential company business records. Inferring scienter from such access would automatically "subject any accountant or high-ranking company official to liability" for any fraud committed by others in the company. *Queen Uno L.P. v. Coeur d'Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1360 (D. Colo. 1998). Thus, 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." *Ibid.* The complaint offers no specifics to give flesh to its barebones allegations about Andersen's "access" to unspecified internal information at Household.

C. Plaintiffs Concede That Mere Allegations of GAAP and GAAS Violations Do Not Raise The Required Strong Inference of Scienter.

Plaintiffs concede that mere allegations of GAAP or GAAS violations are insufficient to raise the required strong inference of scienter. *See* Pl. Br. 8-9.[1] The reason, of course, is that negligence is not fraud, and negligent conduct does not give rise to the required strong inference

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[1] *See, eg., Chill v. General Elec. Corp.*, 101 F.3d 263, 270 (2d Cir. 1996) ("[a]llegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent, are not sufficient to state a securities fraud claim."). Rather, plaintiffs must show that the accounting errors were so "obvious" that the auditor must have known of them or "consciously disregarded" them. *Comshare Sec. Litig.*, 183 F.3d 542, 553 (6th Cir. 1999). *See also* cases cited at Andersen's Opening Brief at 8-9.

of intent to deceive.[2] Plaintiffs do not dispute that to state a claim of securities fraud against an outside auditor, they must allege facts showing that:

> The accounting firm's practices amounted to no audit at all, or to an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.

Chu, 100 F. Supp. 2d at 823-24. *Accord*, *Danis*, 121 F. Supp. 2d at 1194; *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994). No matter how many times Plaintiffs may attach the words "intentionally or recklessly" to an alleged GAAP or GAAS violation, such conclusory rhetoric cannot convert allegations of ordinary negligence into a claim for fraud.

D. Plaintiffs Fail To Allege Any "Red Flags."

Plaintiffs argue that Household's alleged GAAP violations were accompanied by "red flags" that should have alerted Andersen to Household's purported fraudulent scheme. But Plaintiffs' allegations fail to connect the "red flags" to Andersen. Plaintiffs' "red flags" argument fails at the outset because it is only an auditor's "*deliberately ignoring* 'red flags'" that some courts have found will support an inference of scienter. *See First Merchant's Acceptance Corp. Sec. Litig.*, 1998 WL 781118, at *10 (N.D. Ill. Nov. 4, 1998) (attached as Exhibit 2) (quoting *Miller v. Material Sciences Corp.*, 9 F. Supp. 2d 925, 928 (N.D. Ill. 1998)). As one court recently explained, those cases where an auditor's alleged disregard of red flags has

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[2] Although recklessness may give rise to an inference of scienter under Section 10(b), "courts adopting such an approach have relied on a stringent formulation of the term 'reckless' that does not allow for recklessness as a form of negligence." *Comshare Sec. Litig.*, 183 F.3d at, 548. Rather, recklessness for purposes of Section 10(b) must be "understood as a mental state apart from negligence and akin to conscious disregard." *Id.* at 550 & n.7. *See also Silicon Graphics*, 183 F.3d at 979 ("[P]laintiffs proceeding under the [PSLRA] * * * must state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent."); *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 241 (S.D.N.Y. 1997) (recklessness for purposes of Section 10(b) "describes a conscious state of mind that is inherently deceptive."). Put another way, Plaintiffs must "demonstrate that the deceit was committed with the intent to mislead or at least with a recklessness *so severe that it is the functional equivalent of intent.*" *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir. 1995) (emphasis added).

contributed to a strong inference of scienter have "included specific facts suggesting that the auditor *consciously entertained doubts* about the veracity of its client's financial disclosures, either from a client or a third party *informing the accountant* of the client's fraud, or from contemporaneous *statements made by the accountants*." *Reiger v. Price Waterhouse Coopers LLP*, 117 F. Supp. 2d 1003, 1012 (S.D. Cal. 2000), *aff'd sub nom. DSAM Global Value Fund v. Altris Software*, 288 F.3d 385 (9th Cir. 2002) (emphasis added) (reviewing cases). Where, as here, the supposed "red flags" are merely facts that plaintiffs contend *could* have been discovered by the auditor or *should* have led the auditor to dig deeper, the complaint provides no basis to charge the auditor with fraud, rather than (at most) garden variety negligence. *See ibid.* ("Plaintiffs' purported 'red flags' consist of Price Waterhouse's possession of documentation which, if properly reviewed pursuant to GAAP and GAAS, would have revealed improperly recognized revenue. At most, the allegations raise an inference of gross negligence, but not fraud.").

The paradigm "red flag" for purposes of stating a fraud claim against an auditor is a tip provided by a corporate insider or other knowledgeable person that places the auditor on actual notice of the client's suspected fraud. *See In re Ikon Office Solutions, Inc. Sec. Litig.*, 66 F. Supp. 2d 622, 630 (E.D. Pa. 1999) (auditor told at Audit Committee meeting that company's CFO was "cooking the books"); *In re Health Management Inc. Sec. Litig.*, 970 F. Supp. 192, 203 (E.D.N.Y. 1997) (auditor received an analyst's letter that specifically warned that management had artificially inflated the company's accounts receivables); *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1345 (S.D. Fla. 1999) (auditor "tipped off" by company employees that company was overstating its reserves). No such tips are alleged here. Instead, Plaintiffs' allegations here are like those deemed insufficient in *Reiger*, 117 F. Supp. 2d at 1012, where the court noted that

"Plaintiffs do not identify any letters, notes, memos, telephone calls, or conversations that expressly or even impliedly suggest that Price Waterhouse was on notice of Altris' revenue scheme." *See also Cheney v. Cybergard Corp.*, 2000 WL 1140306, at *11 (S.D. Fla. July 31, 2000) (dismissing complaint against auditor where "there is no allegation that KPMG was ever approached by an employee of Cybergard with the information.") (attached as Exhibit 3).

Lacking any evidence of a real "red flag," Plaintiffs are reduced to arguing that Household's alleged accounting violations are themselves the "red flags" that Andersen ignored. *See* Pl. Br. 4, 8. Such rhetorical sleight of hand cannot convert allegations of ordinary negligence into a claim for fraud. *See, e.g., Holmes v. Baker*, 166 F. Supp. 2d 1362, 1379-80 (S.D. Fla. 2001) (dismissing 10b-5 claim against auditor where the purported "red flags consist[ed] primarily of rehashes of the GAAP violations"); *In re Sunterra Corp. Sec. Litig.*, 199 F. Supp. 2d 1308, 1338 (M.D. Fla. 2002) (motion to dismiss granted where the alleged "red flags" amounted to nothing more than additional GAAP violations).

Plaintiffs rely primarily on three cases to support their "red flags" argument, but the allegations in Plaintiffs' complaint are nothing like the allegations in those cases of *specific disclosures made by or to the auditor* showing that the auditor consciously entertained doubts about the veracity of the financial statements. *See First Merchant's Acceptance Corp. Sec. Litig.*, 1998 WL 781118, at *4 (auditor furnished letter to audit committee reflecting "reportable conditions" at First Merchants "relating to significant deficiencies in the design or operation of the internal control structure that * * * could adversely affect the Company's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements"); *Great Neck Capital Appreciation*, 137 F. Supp. 2d 1114, 1123 (E.D. Wis. 2001) (auditor acknowledged in a letter that company's division had incurred severe cost

overruns, had not undertaken a cost analysis and "knew that [the company] did not have the ability to accurately estimate the costs of completing the projects," but still certified the company's financial statements); *Chu*, 100 F. Supp. 2d at 824 (company's CEO told shareholders that "[company] and [auditor] have developed a 'brilliant strategy' to fund [company's] research and development costs 'off the balance sheet' by transferring expenses to [other companies] as licensing or loan agreements."). As we show below, Plaintiffs have not come close to alleging the same types of facts in this case.

1. "Predatory Lending" Allegations

Plaintiffs argue that if Andersen had conducted a "comprehensive" audit, it would have discovered and disclosed Household's alleged "predatory lending" practices. Pl. Br. 2, 6-7. Apparently, Plaintiffs contend that if Andersen had reviewed some undefined sample of Household's 50 million customer accounts, and verified the underlying mortgage and consumer loan agreements, outstanding balances, interest rates and fees, Andersen would have discovered that some of these loans had high upfront fees, high loan-to-value ratios, carried credit insurance, were associated with secondary loans with high interest rates, or otherwise contained terms that Plaintiffs believe were unfair to consumers. *See* Pl. Br. 2, 6-7. Among many other problems, Plaintiffs' argument fundamentally misunderstands the role of an auditor.

The role of an auditor is to issue an opinion on the audited financial statements, not to function as some sort of all-purpose compliance officer reviewing the company's transactions for legality or fairness to customers. *See Latigo Ventures v. Laventhol & Horwath*, 876 F.2d 1322, 1326 (7th Cir. 1989) (rejecting a "theory of whistleblower liability" that maintained that "accountants who participate in or even are merely aware of a fraud by a client have a duty under Rule 10b-5 [to] broadcast that fraud to anyone who might buy the client's stock."). As the Seventh Circuit stated in *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990), "[a]lthough

accountants must exercise care in giving opinions on the accuracy and adequacy of firms' financial statements, they owe no broader duty to search and sing."

As the Complaint concedes, Andersen's audit opinions addressed solely the material accuracy of Household's audited financial statements, and not the "fairness" of Household's transactions with consumers. The audit opinions, which are quoted in the Complaint, stated that Andersen had concluded, based on its audit procedures, that Household's audited year-end financial statements "present fairly, in all material respects, the financial position of Household" for the covered period, in conformity with GAAP. *See* Cmplt. ¶ 174 (quoting audit opinion). The Complaint's "predatory lending" allegations (Cmplt. ¶¶ 51-106) fail to link the alleged business practices to any material error in Household's audited financial statements. Plaintiffs fail to allege any facts showing that the alleged practices caused any (much less all) of Household's year-end financial statements to be materially in error during the class period. Nor are any facts alleged to show that the practices were so widespread or pervasive that the risk of civil liability was sufficiently likely – and that the amount of such liability could be reasonably estimated – to allow the company to establish a loss contingency reserve during the time periods covered by Andersen's audits. *See* Cmplt. ¶ 104 (acknowledging that Statement of Financial Accounting Standards ("SFAS") No. 5, Accounting for Contingencies, provides that a loss reserve can be established for a contingent liability only "when the estimated loss is probable and reasonably estimated.").

Plaintiffs point to the fact that Household ultimately agreed to a settlement with the states' attorneys general of alleged predatory lending claims (the "AG Settlement"). The Complaint admits, however, that the AG Settlement took place in the fourth quarter of 2002 – *after* the period covered by Andersen's audits. *See* Cmplt. ¶ 5. Household accounted for the

settlement as a charge against the company's earnings in 2002, and no facts are alleged to suggest that the settlement should have (or could have) been accounted for in any earlier period. After all, KPMG, Household's successor auditor, did *not* recommend that Household restate any prior period financial statements as a result of the AG Settlement. The concurrence of KPMG that the AG Settlement be treated as a current-period event, and that no prior-period financial statements be restated for its effect, refutes Plaintiffs' attempt to show that Andersen's judgments were such that "no reasonable accountant would have made the same decisions if confronted with the same facts." *See Ikon Office Solutions Sec. Litig.*, 277 F.3d 658, 669 (3d Cir. 2002) (fact that another accounting firm decided that restatement was not necessary "undermines any suggestion that [the prior auditor] could not reasonably have opined that [the company's] financial statements fairly presented its financial condition in accordance with GAAP.").

Plaintiffs' argument that Andersen should have predicted the likelihood and amount of the liability the company might incur from the alleged "predatory lending" practices (apparently by reviewing the underlying consumer loans for compliance with various state legal requirements, *see* Pl. Br. 6) not only misconceives the role of an outside auditor, it is also a blatant attempt to allege "fraud by hindsight." As the Seventh Circuit instructed in *DiLeo*, "[t]here is no fraud by hindsight." *DiLeo*, 901 F.2d at 628 (quoting *Denny v. Barber*, 576 F.2d 465, 470 (2d Cir. 1978)). As the Sixth Circuit similarly pointed out, "mere allegations that statements in one report should have been made in earlier reports do not make out a claim of securities fraud." *Comshare*, 183 F.3d at 553. But that is exactly what Plaintiffs try to do here.

Plaintiffs are reduced to arguing that Andersen should have predicted the 2002 liability because Household was subject to several law suits and charges of predatory lending in 2001. But of course *unproven allegations* in lawsuits which were denied by the company are hardly

probative, and an auditor is not in a position to reach a conclusion as to the legal merits of such disputed claims, much less to predict the likely outcome of the litigations (which were disclosed to the market by the company). Again, Plaintiffs' argument is merely fraud by hindsight, and no facts are alleged to suggest that the failure to predict the AG settlement could possibly amount even to negligence, much less fraud. *See, e.g., Kushner v. Beverly Enterprises, Inc.*, 317 F.3d 820, 827 (8th Cir. 2003) (rejecting securities fraud claim predicated on alleged failure to establish sufficient reserves to cover a subsequent civil settlement because without allegations of particular facts showing that defendants "knew the financial statements overrepresented the company's true earnings" "at the time they made their statements," "a showing in hindsight that the statements were false does not demonstrate fraudulent intent.").

Nor can Plaintiffs raise an inference of scienter based simply on the "magnitude" of Household's later settlement with the state attorneys general. *See Kushner*, 317 F.3d at 829 (Eight Circuit declined to infer "that the scheme was widespread throughout the company and known by the defendants because of the sheer size of the civil settlement," in the absence of specific factual allegations showing that "defendants had knowledge of contradictory crucial information at the time they made their statements of compliance."). The problem with Plaintiffs' argument based on the size of the AG Settlement is that it is simply more conjecture based on hindsight. In the first place, a settlement of a claim is not an admission of liability and cannot show that Household in fact engaged in any illegal practices, much less that those practices were pervasive, or known to the outside auditor. *Eg., Lipsky v. Commonwealth United Corp.*, 551 F.2d 887, 893 (2d Cir. 1976). Beyond that, the size of a settlement may be influenced by many factors, and cannot justify an inference of scienter even as to the company, much less as to an outside auditor who was not a party to the settlement or the litigation. Indeed, even the size

of a restatement cannot justify an inference of scienter. As the court in *Reiger*, 117 F. Supp. 2d at 1013, explained:

> To travel from magnitude of fraud to evidence of scienter, the court must blend hindsight, speculation and conjecture to forge a tenuous chain of inferences: (1) because the magnitude of the fraud was large, conspicuous warning signs must have existed; (2) these warning signs must have been available to the outside accountant during the audit; (3) these warning signs must have made the fraud obvious and conspicuous to the accountant; and therefore (4) the accountant must have known of the fraud. * * * To avoid undermining the policies of the [PSLRA] through reliance on hindsight and speculation, a court should not infer an independent accountant's scienter based solely on the magnitude of its client's fraud.

"To hold otherwise would obviate the scienter requirement. Plaintiffs would be able to satisfy this requirement merely by alleging that a particular statement was severely false * * *, [which] would ignore the reality that scienter and falsity are distinct elements of a Section 10(b) claim." *Duncan v. Pencer*, 1996 U.S. Dist. LEXIS 401, at *35 (S.D.N.Y. Jan. 18, 1996) (attached as Exhibit 4). *See also DiLeo*, 901 F.2d at 627 ("Four billion dollars is a big number, but even a large column of big numbers need not add up to fraud.").

Because no facts are alleged in the Complaint to suggest that Andersen's audit opinion was even false by virtue of the company's alleged predatory lending activities, much less that Andersen knew of or recklessly disregarded some material error in the audited financial statements, Plaintiffs have no claim against Andersen based on their theory that Household engaged in "predatory lending" practices.

Moreover, because Andersen never claimed to have reviewed Household's millions of consumer loans to determine whether the terms were "fair," and never provided an opinion certifying Household's compliance with whatever laws may have governed Household's lending activities, Plaintiffs can state no claim against Andersen based on Household's purported failure to disclose its alleged "predatory lending" practices. *See, e.g., Shapiro v. Cantor*, 123 F.3d 717,

721 (2d Cir. 1997) (auditor not "responsible for the company's public statements" as to which the auditor issued no opinion, even if "the accountant may know those statements are likely untrue"); *Danis*, 121 F. Supp. 2d at 1193 (rejecting §10(b) claim against auditor based on company's "unaudited reports" that the auditor reviewed); *Tricontinental Indus. v. Anixter*, 184 F. Supp. 2d 786, 788 (N.D. Ill. 2002) (auditor not liable for "the statements of others" as to which the auditor has not issued an opinion).

The Second Circuit's decision in *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), is instructive. The court affirmed dismissal of a Section 10(b) claim against an auditor who allegedly reviewed and orally approved the financial information contained in a press release issued by the audit client. In rejecting plaintiff's argument that the market "understood" the press release as an implied representation by the auditor that the financial information contained in the press release was accurate, the Second Circuit explained that holding an auditor liable for the statements of the company where the auditor had made no public statement regarding the matter would "effectively revive aiding and abetting liability under a different name" and run afoul of the Supreme Court's holding in *Central Bank v. First Interstate Bank*, 511 U.S. 164, 177 (1994), that Section 10(b) does not authorize a claim against aiders and abetters to securities fraud. Here, as well, because Andersen made no statements regarding the "fairness" of Household's consumer loans, and because Plaintiffs' complaint fails to allege any facts linking Household's purported "predatory lending" practices to an error in the one statement Andersen made – its audit opinions on the financial statements – Plaintiffs can state no claim against Andersen based on their "predatory lending" theory.

2. Reaging Allegations

Plaintiffs' allegations regarding Household's allegedly improper reaging of delinquent accounts barely mention Andersen, and provide no facts to suggest that Andersen was aware of,

or recklessly disregarded, any material error in Household's audited financial statements. On page 5 of their response, Plaintiffs claim that "Andersen knew or recklessly disregarded highly suspicious facts regarding reaging." They argue that Andersen should have detected, through sampling, that a certain percentage of Household's accounts had been reaged multiple times and that Household's subsequent auditor identified these alleged facts and "caused Household" to disclose its reaging statistics. Pl. Br. at 5. Although plaintiffs cite to paragraphs 14, 123-24, 127-28, 174 and 323 of the Complaint as support, none of those paragraphs makes any reference to what Andersen "should have known" and none of them pleads any facts indicating that KPMG "caused" Household to disclose its reaging statistics. In fact, paragraph 174 is the only paragraph that even mentions Andersen – and that is only to quote Andersen's audit report. None of plaintiffs' cited allegations even references – much less states with particularity – what Andersen knew or should have known with respect to the reaging issue. *See DiLeo*, 901 F.2d at 626, 629 (affirming dismissal of 10b-5 complaint asserting that bank's auditor closed its eyes to problems with bank's loan portfolio and inadequacy of loan loss reserve where complaint failed to "give examples of problem loans that [the auditor] should have caught, or explain how it did or should have recognized that the provisions for reserves established by the bank's loan officers were inadequate"; requiring plaintiff to allege facts showing that the auditor "knew that particular loans had gone bad and could not be collected").

Moreover, no facts are alleged in the Complaint to show that Household's alleged reaging of certain delinquent accounts caused any material error in the year-end financial statements audited by Andersen, much less that Andersen knew of or recklessly disregarded any such error. Even if KPMG did "require" Household to break out its reaging statistics beginning in the second quarter of 2002 (and facts supporting this claim are not alleged), this cannot show that the

failure to do so earlier was fraudulent. *See Comshare*, 183 F.3d at 553 ("[M]ere allegations that statements in one report should have been made in earlier reports do not make out a claim of securities fraud."). Moreover, Plaintiffs can hardly suggest that KPMG believed Household's reaging practices caused the year-end financials audited by Andersen to be in material error, given the fact that KPMG did *not* require that Household restate any prior period financial statements based on the reaging issue. Indeed, the notion that KPMG "required" a separate disclosure of reaging statistics going forward, and did not require a restatement, completely belies Plaintiffs' argument (Pl. Br. 11) that the fact that KPMG did not require a restatement is not telling. It is. KPMG specifically looked at the matter and determined that a restatement was not appropriate. Thus, Plaintiffs can hardly show that Andersen's accounting judgments were "such that no reasonable accountant would have made the same decisions if confronted with the same facts." *Chu*, 100 F. Supp. 2d at 823-24. *See Ikon*, 277 F.3d at 669 (fact that another accounting firm concluded that restatement was not necessary undermines inference of scienter as to prior auditor).

Here again, Plaintiffs' "reaging" argument also misconstrues the role of an auditor. An auditor opines on the material fairness of the financial statements taken as a whole. Andersen provided no opinion concerning Household's reaging practices or statistics. The issue for the auditor is simply whether the loan loss reserve is adequate so that the company's net income is not misstated. No facts are alleged in the Complaint to suggest that Household's loan loss reserve was inadequate, or its income misstated, during the period covered by Andersen's audits. No facts are alleged to suggest that Household's allegedly arbitrary reaging practices were sufficiently pervasive to affect Household's bottom line.

Even if Plaintiffs had alleged facts to show that Household's reaging practices caused a material error in some financial statement audited by Andersen – and they have not done so – such a showing would be insufficient, by itself, to allege scienter. After all, as Plaintiffs concede, a violation of GAAP or GAAS does not constitute scienter. *See supra* at 5-6. Plaintiffs argue that Andersen could have detected a discrepancy in Household's delinquency rates by examining some undefined sample of the millions of underlying loans and discovering that some loans had been reaged arbitrarily. But Plaintiffs cite no professional standard to show that an auditor is required to engage in such an exercise, or why the failure to do so (if such a review were required by applicable professional standards) would amount to anything more than simple negligence, rather than fraud.

Once again, Plaintiffs can point to no "red flags" worthy of that designation. Plaintiffs argue that Andersen was on notice of the alleged reaging scheme because: Household reported greater growth and earnings than other companies in the industry; Household shifted credit card receivables from its banking unit to a non-bank subsidiary; and Household's executive compensation program was tied to financial performance. *See* Pl. Br. 6. None of these facts are even particularly suspicious, much less red flags. For example, Plaintiffs argue that Household's transfer of credit card receivables was done to avoid delinquency reporting requirements applicable to banks, but no *facts* are alleged in the Complaint to support that conjecture. Nor are any facts alleged to show why Andersen should have suspected fraud simply because Household was successful and (like many companies) compensated executives in part based on the company's financial performance. *See, e.g., Oran v. Stafford*, 226 F.3d 275, 290 (3d Cir. 2000) (executive's sale of company stock does not support inference of scienter unless "unusual in scope or timing").

Finally, Plaintiffs argue that Household entered into a consent order with the SEC that found that Household had made false and misleading statements regarding its reaging practices. Pl. Br. 5-6. This argument fails on multiple levels. *First*, the consent order is not even mentioned in the Complaint, and cannot be used to somehow cure the Complaint's insufficient reaging allegations. *See Harrell v. United States*, 13 F.3d 232, 236 (7th Cir. 1993) (plaintiff cannot cure deficiencies in complaint "by inserting the missing allegations in a document that is not either a complaint or an amendment to a complaint"). *Second*, an SEC consent order is a negotiated settlement rather than an adjudication of the issues, and is not evidence of the truth of the claims against Household where, as here, the consent order contains no admission of liability. *See* RJN, Ex. 2 at 3-4 (consent order stated it was not an admission of liability); *Lipsky*, 551 F.2d at 893 (consent order "can not be used as evidence in subsequent litigation between [the] corporation and another party."). *Third*, Andersen was not even a party to the consent order, so it could hardly be considered an admission of anything by Andersen. *Fourth*, although the consent order stated the SEC's position that Household in certain of its public statements did not adequately describe its reaging practices, the SEC did *not* contend that Household's reaging practices were arbitrary or improper. *See* RJN, Ex. 2. The SEC did *not* claim that Household's loan loss reserves were calculated in violation of GAAP or that they should have been higher. *Ibid.* The SEC did *not* require or even recommend that Household restate any financial statements. *Ibid.* The consent order did *not* require Household to write off any loans or to take larger loan loss reserves. *Ibid.* Thus, if the consent order has any relevance at all, it refutes rather than supports Plaintiffs' theory that Household's reaging practices caused the audited financial statements to be in material error.

3. Cost Accounting Allegations

Plaintiffs claim to have "allege[d] that Andersen had direct knowledge of the specific, highly suspicious facts regarding Household's improper accounting." Pl. Br. 3. In support of that assertion, Plaintiffs cite paragraphs 135 and182 of the Complaint. Paragraph 135 merely alleges that KPMG concluded that the amortization rates "approved by Andersen" for Household's co-branding and affinity credit card agreements and marketing agreements were improper, and that Household "corrected its amortization schedules for prepaid expenses related to those agreements," recognized expenses immediately (rather than over the life of the contract) for the marketing agreements, and restated previously reported financial results to account for the change. Paragraph 182 merely quotes Statement of Auditing Standards No. 82, dealing with fraud risk factors, and asserts in completely conclusory terms that Andersen "knew" that Household possessed "many" of the risk factors delineated therein.[3] What is missing from the Complaint are any *facts* to indicate that Andersen knew or recklessly disregarded that Household's amortization rates were incorrect. Plaintiffs offer allegations that KPMG disagreed with Andersen over the proper amortization periods, but no facts to show that this was anything other than a good-faith disagreement among accountants concerning a complex accounting issue.

In an attempt to save their cost accounting allegations, Plaintiffs again go beyond the pleadings and offer the transcript of an August 14, 2002 Household conference call regarding the restatement. *See* Pl. Br., Ex. B. Plaintiffs cite the conference call transcript to argue that the

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[3] Plaintiffs do not even contend that many of the risk factors listed in SAS No. 82 were present at Household. See Cmplt. ¶ 182. As the audit guidance states, the consideration of fraud risk factors when planning the scope of an audit is a matter of complex "professional judgment" and the risk factors "cannot easily be ranked in order of importance or combined into effective predictive models." AU § 316.21. The Complaint alleges no facts indicating that Andersen failed to exercise appropriate professional judgment in considering the fraud risk factors. But even if the Complaint did allege such facts, that would at most make out a claim of negligence, not fraud.

"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." Pl. Br. 4, citing Ex. B at 2. First, the FASB wrote the requirements in EITF Release No. 93-1, not Andersen or any individual at Andersen. (Official EITF literature represents a consensus opinion and cannot be "written" by any individual accountant). In any event, the Complaint alleges no facts to show that the Andersen accountant who assisted with the drafting did not genuinely believe that Household was using the correct amortization periods for the cobranding agreement. Indeed, the conference call transcript submitted by Plaintiffs *refutes* rather than supports such a theory, stating that the restatement arose from "good faith differences of opinion" between Andersen and KPMG over "complicated" accounting issues (which included (a) whether the guidance provided by Emerging Issues Task Force Release No. 93-1 should be applied to existing contracts or only on a prospective basis, (b) the highly judgmental issue of whether an action was a modification, and (c) whether a modification, if any, to an existing agreement was significant enough to warrant application of the new GAAP in EITF No. 93-1, which represented a change from prior acceptable methods and provided new specific guidance where none existed before). Pl. Br. Ex. B at 1-3. And, as a professional matter, Andersen did not agree with the restatement.

In short, neither the Complaint nor the conference call transcript (should that even be considered) provides any basis – much less the required strong basis – to infer that the restatement arose from fraud rather than from a good-faith disagreement between accountants regarding a complex matter of professional judgment.

"Restatements of earnings are common." *Goldberg v. Household Bank, F.S.B.*, 890 F.2d 965, 967 (7th Cir. 1989). The mere fact that an accounting item is restated is not sufficient to

raise the required strong inference of scienter. *See, e.g., Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 433 (5th Cir. 2002) (no inference of scienter from restatement where complaint's allegations were consistent with negligence rather than fraud); *SCB Computer Tech. Sec. Litig.*, 149 F. Supp. 2d 334, 353 (W.D. Tenn. 2001) ("[a]llowing for a strong inference of scienter from restated financial results when the practices leading to the original financial results fail to support a strong inference of scienter would be equivalent to building a house without a foundation"); *Cheney* 2000 WL 1140306, at * 12 ("the magnitude of the restatement does not, without evidence that the auditor was aware of the falsity of the original statements, raise an inference of scienter"). Indeed, the accounting standard cited by Plaintiffs in their brief (Pl. Br. 4), Accounting Principles Board Opinion ("APB") No. 20, recognizes that a restatement can result from "mistakes in the application of accounting principles." *See* APB No. 20, ¶ 13. "[I]t is difficult to build inferences of scienter upon accounting errors because such errors often involve complex calculations about which reasonable people can differ in opinion." *In re Allscripts, Inc. Sec. Litig.*, 2001 WL 743411, at *11 (N.D. Ill. June 29, 2001) (attached as Exhibit 5).[4] Such is the case here, and the Complaint alleges no facts to suggest otherwise.

E. Plaintiffs Fail To Refute Andersen's Showing That Plaintiffs' Allegations Regarding Andersen's Fees Are Insufficient To Raise An Inference Of Scienter.

As Andersen showed in its opening brief, the Complaint's boilerplate allegations that Andersen earned fees for its auditing and consulting work for Household and wished to keep Household as a client (Cmplt. ¶¶ 46, 177, 178) are insufficient to allege scienter on the part of an auditor. *See* Andersen Br. 7 and cases cited therein. This is because all accounting firms are in

[4] Plaintiffs cite *In re MicroStrategy Iinc. Sec. Litig.*, 115 F. Supp. 2d 620 (E.D. Va. 2000) for the proposition that "[a] restatement can support scienter against an auditor." Pl. Br. 4. But in *MicroStrategy*, the auditor entered into a "partnership" with the audit client "by agreeing to sell [the client's] products." 115 F. Supp. 2d at 654-55. Obviously, no such facts are or could be alleged here.

the business of providing services for a fee, and allowing plaintiffs to plead scienter based on an auditor's desire to earn fees "would universally eliminate the state of mind requirement in securities fraud actions against accounting firms." *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994).

Thus, to support an inference of scienter against an auditor based on the receipt of professional fees, a plaintiff must at a minimum allege facts showing that the fees were somehow unusual, *i.e,* inordinately high, out of line with what other firms would have charged for the work performed, or an important proportion of the accounting firm's revenues. *See Oran*, 226 F.3d at 290 (sale of stock does not support scienter unless "unusual in scope or timing"). There are no such allegations here.

Plaintiffs argue that the court in *Complete Mgmt. Sec. Litig.*, 153 F. Supp. 2d 314 (S.D.N.Y. 2001) (cited at Pl. Br. 11-12), found that the receipt of only $1 million in consulting fees supported an inference of scienter. But in that case, unlike here, there were other allegations offered, apart from the fees, to raise a strong inference of scienter: the complaint included detailed factual allegations showing that the audited company's largest (and for a time *sole*) client was a fraudulent "medical mill" whose receivables were often uncollectible although the audited company maintained *no* reserve for doubtful accounts. *Id.* at 318-19, 325, 334-35. The court did not rely simply on the receipt of fees to raise the "plausible" inference of scienter. (Indeed, the court actually held that "[t]he desire for future auditing fees is * * * insufficient as a matter of law to state an inference of fraud under the motive-and-opportunity theory." *Id.* at 335.[5])

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[5] Plaintiffs also rely on *Frymire-Brinati v. KPMG Peat Marwick*, 2 F.3d 183, 191 (7th Cir. 1993) (cited at Pl. Br. 12), but that case has nothing to do with the requirements for pleading scienter under the PSLRA. *Frymire* predated the PSLRA. Moreover, the court had entered judgment *for* the auditor on all (cont'd)

Because the Complaint does not allege that Andersen's fees from the Household work were in any way unusual or anything more than a small fraction of Andersen's total revenues, there is no rational basis for an inference of scienter. *See, e.g., DiLeo*, 901 F.2d at 629 (rejecting similar "irrational" motive allegations because "[f]ees for two years' audits could not approach the losses [the firm] would suffer from a perception that it would muffle a client's fraud"); *Danis*, 121 F. Supp. 2d at 1195 (rejecting argument that scienter could be shown by auditor's desire to preserve multi-million dollar consulting work because "this amount of money, even coupled with similar future earnings, falls vastly below the potential loss of income and good will that [the auditor] would sustain if its reputation were damaged by fraudulent business practices"). As the Seventh Circuit stated in *DiLeo*, "[p]eople sometimes act irrationally, but indulging ready inferences of irrationality would too easily allow the inference that ordinary business reverses are fraud." 901 F.2d at 629. Thus, "[o]ne who believes that another has behaved irrationally has to make a strong case." *Ibid.* The Complaint fails to do so.

F. Plaintiffs' Allegations Regarding Other Litigation Against Andersen Are Insufficient To Raise An Inference Of Scienter.

In a blatant attempt to poison the well, Plaintiffs argue that their claims concerning Andersen's audits of Household must be sufficient because Andersen has been sued over other audits conducted by other professionals of other companies with different financial statement issues. *See* Pl. Br. 12, citing Cmplt. ¶¶ 180-81. Plaintiffs' need to rely on such allegations merely highlights their inability to state a claim concerning the audits at issue in this case. Andersen has separately moved to strike the allegations concerning other audits and litigations

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(... cont'd)

federal securities claims, so only state law claims remained. *Id.* at 90. As to the state law claims, a jury found *direct* evidence of fraud.

contained in paragraphs 180-81 of the Complaint, and incorporates the arguments made on that motion to strike herein.

G. When Considered In Its Totality, the Complaint Fails To Allege Scienter As To Andersen.

Plaintiffs argue that although each of their allegations may fail to raise an inference of scienter, they are sufficient when "considered in their totality." Pl. Br. 8. Andersen agrees that Plaintiffs' allegations must be considered in their totality, but a long line of zeros still adds up to zero, and "combin[ing] inadequate allegations of motive with inadequate allegations of recklessness" cannot demonstrate scienter. *Kalnit v. Eichler*, 264 F.3d 131, 141 (2d Cir. 2001).

There is also no merit to Plaintiffs' argument that the Complaint should not be dismissed, even though "some questions remain unanswered," because "there has been no discovery." Pl. Br. 11. The PSLRA provides for an automatic stay of discovery during the pendency of a motion to dismiss (*see* 15 U.S.C. § 78u-4(b)(3)(B)) because "Congress clearly intended that complaints in these securities actions shall stand or fall based on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed." *Medhekar v. U.S. Dist. Ct.*, 99 F.3d 325, 328 (9th Cir. 1996). *See also Faulkner v. Verizon Communications, Inc.*, 156 F. Supp. 2d 384, 406 (S.D.N.Y. 2001) (PSLRA discovery stay was designed to end the "abusive" practice of filing suit with only a "faint hope" that discovery might uncover "any shred of evidence").

II. PLAINTIFFS FAIL TO REFUTE ANDERSEN'S SHOWING THATCOUNT I MUST BE DISMISSED AS TO ANDERSEN FOR FAILURE TO ALLEGE LOSS CAUSATION.

As pointed out in Andersen's opening brief, in the Seventh Circuit, a plaintiff alleging a violation of Section 10(b) must allege facts showing that 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 Bastian v. Petren Res. Corp.*, 892 F.2d 680, 684-85 (7th Cir. 1990); *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 931 (7th Cir. 1988). 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. ¶ 140. Moreover, the complaint itself supports the fact that any decline in the value of Household's stock is not attributable to the restatement – the complaint and the response brief attribute the decline in the value of Household stock to the alleged predatory lending practices, reaging of delinquent accounts and various other representations and statements allegedly made by Household.

Plaintiffs argue that the mere fact that Household's stock closed higher on the day of the restatement does not "absolve" Andersen because the Ninth Circuit has rejected a bright-line rule requiring an immediate market reaction. Pl. Br. 12. But in the Seventh Circuit, a plaintiff cannot argue that the market "only sometimes" reacts to negative economic news and then selectively choose which negative reactions a court should consider. *See Roots Partnership v. Lands' End, Inc.*, 965 F.2d 1411 (7th Cir. 1992) ("Roots has failed to allege loss causation, however, because the fraud-on-the-market theory under which Roots proceeds presumes that news is promptly incorporated into the stock price.") *citing Wieglos v. Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir. 1989). Here, the market reaction shows that Plaintiffs simply suffered no loss based on the restatement of items in the Household financial statements audited by Andersen.

Plaintiffs also misstate the law in arguing that "loss causation is sufficiently pled where plaintiffs alleged 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." Pl. Br. 14. Loss causation requires that the plaintiff suffer a "loss" as a result of purchasing stock at a price inflated by material misstatements. *See, e.g., Carmark, Inc. v. Coram Healthcare*

Corp., 113 F.3d 645, 649 (7th Cir. 1997); *The Roots Partnership v. Lands' End Inc.*, 965 F.2d 1411 (7th Cir. 1992); *Bastian*, 892 F.2d at 684; *Tatz v. Nanophase Technologies Corp.*, 2002 U.S. Dist. LEXIS 19467, at *22 (N.D. Ill. Oct. 9, 2002) (included with plaintiffs supporting materials at Ex. 40).

Finally, Plaintiffs argue that the rise in Household's stock price on the day of the restatement is insignificant because the stock price was inflated by "Household's continued misrepresentations." Pl. Br. 13. Under Plaintiffs' theory, Plaintiffs have not suffered a loss as a result of misstatements made by *Andersen*.

III. PLAINTIFFS FAIL TO REFUTE ANDERSEN'S SHOWING THAT COUNTS III AND IV ARE BARRED BY THE APPLICABLE STATUTE OF LIMITATIONS.

Plaintiffs do not dispute that their Section 11 claim against Andersen is time-barred under the one-year/three-year statute of limitations that applies to § 11 claims by virtue of § 13 of the 1933 Act. *See* 15 U.S.C. § 77m.[6] Recognizing that their claim is untimely under § 13, Plaintiffs argue that the Sarbanes-Oxley Act's two-year/five-year statute of limitations applies. This argument is refuted by the clear language of Sarbanes-Oxley and has been rightly rejected by every court to have considered it.

As Plaintiffs acknowledge, "[a]ny question of statutory interpretation begins with an examination of the text of the statute to determine whether its meaning is clear." Pl. Resp. to Household Mot. 46. Here, the meaning is crystal clear.

Section 804 of the Sarbanes-Oxley Act (Pub. L. No. 107-204 (July 30, 2002)) expands the statute of limitations for any "private right of action that involves *a claim of fraud, deceit,*

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[6] Plaintiffs not only fail to plead compliance with the one-year/three-year statute of limitations, they concede in the Complaint that that this lawsuit was filed more than three years after the securities in question were first bona fide offered to the public. *See* Cmplt. ¶ 357. Plaintiffs allege only that they have brought their complaint within *two* years of their discovery of the alleged misstatements and within *five* years of the time the securities were offered. *See* Cmplt. ¶¶ 381 (Count III), 394 (Count IV).

manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934." 28 U.S.C. § 1658(b) (emphasis added). On its face, Sarbanes-Oxley's expanded statute of limitations applies only to securities claims involving "fraud, deceit, manipulation, or contrivance." Those terms connote intentional or willful conduct designed to deceive or defraud investors and "proscribe a type of conduct quite different from negligence." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976). Section 11 claims, on the other hand, do not depend on fraud, as Plaintiffs themselves recognized by expressly disclaiming in Counts III and IV any allegations of fraud or intentional or reckless misconduct. *See* Cmplt. ¶¶ 354, 383.

Plaintiffs concede that the terms "fraud," "deceit" and "manipulation" in § 804 of the Sarbanes-Oxley Act all connote scienter-based claims, but insist that the term "'contrivance' is not suggestive of fraud or intent," and argue that by including the term "contrivance," Congress meant to apply Sarbanes-Oxley's expanded statute of limitations to Section 11 claims. Pl. Resp. to Household Mot., 48-49. This argument fails because the term "contrivance" clearly *does* connote fraud or intentional misconduct, both in judicial usage and in common usage. *See Ernst & Ernst v. Hochfelder*, 425 U.S. at 199 (Congress' use of "the words 'manipulative,' 'device' and '*contrivance*'" in §10(b) "make[s] unmistakable a congressional intent to proscribe a type of conduct quite different from negligence") (emphasis added); *Baum v. Great Western Cities, Inc.*, 703 F.2d 1197, 1212 (10th Cir. 1983) (actual fraud involves "evil design or *contrivance*") (emphasis added). *See also Black's Law Dictionary* 329 (6th Ed. 1990) (defining "contrivance" as "[a]ny device which has been arranged generally to deceive"); *New Webster's Dictionary & Thesaurus* 212 (1992) (defining "contrivance" as "a dishonest device"); *Webster's New Third International Dictionary* (1961) (defining "deceit" as "[a]ny trick, collusion, *contrivance*, false

representation or underhanded practice, used to defraud another") (emphasis added). In common usage, which must be applied in construing the terms of a statute (*Perrin v. United States*, 444 U.S. 37, 42 (1979)), "contrivance," like the terms "fraud," "deceit" and "manipulation," clearly connotes intentional, dishonest conduct.

Apart from their rather contrived attempt to redefine the term "contrivance," Plaintiffs' only argument based on the text of Sarbanes-Oxley is to point out that that Section 804 refers to claims under the "securities laws," as defined by section 3(a)(47) of the Securities Exchange Act, which section in turn includes the 1933 Act in its list of securities laws. Pl. Resp. to Household Mot., 47. But the fact that the expanded limitations period of Sarbanes-Oxley applies to certain claims arising under the "securities laws" does not mean that it applies to *all* claims under those laws. The statute clearly states that it applies only to claims "of fraud, deceit, manipulation, or contrivance."

Plaintiffs' argument that Sarbanes-Oxley expanded the limitations period for Section 11 claims has been rejected by every court to have considered the issue. *See Friedman v. Rayovac Corp.*, 02-C-308-C, slip op. at 2-4 (W.D. Wis. June 20, 2003) (rejecting argument that Sarbanes-Oxley's reference to "securities laws" means that the expanded limitations period applies to *all* claims under the securities laws, and concluding that "the statute is clear that [it] applies only to claims of fraud and, therefore, does not apply to plaintiffs' claims under § 11 and § 12(2) of the 1933 Act.") (Exhibit A to Plaintiffs' Motion for Leave to File Supplemental Authority); *In re Merrill Lynch Co. Inc. Research Reports*, --- F. Supp. 2d ---, 2003 WL 21518833, at * 19 (S.D.N.Y. July 2, 2003) (holding that the expanded statute of limitations of Sarbanes-Oxley Act applies to § 10(b) claims but not to § 11 claims) (attached as Exhibit 6); *In re Mirant Corp. Sec. Litig.*., CA No. 1:02-CV-1467-BBM, slip. op., at 11-12 (N.D. Ga. July 14, 2003) (same).

Lacking any support in either the text of the statute or the cases construing it, Plaintiffs resort to an out-of-context excerpt from the legislative history. As a threshold matter, the Court need not even consider the legislative history because the statutory language is unambiguous. *Barnhill v. Johnson*, 503 U.S. 393, 401-02 (1992) (resort to legislative history inappropriate when statute is unambiguous); *Friedman*, slip op., at 4 (Sarbanes-Oxley statute of limitation is unambiguous so consideration of the legislative history is unnecessary). But should the Court consider it, the legislative history confirms that Congress intended the enlarged statute of limitations to apply only to fraud claims.

In the Congressional Record excerpt cited by plaintiffs, Senator Leahy discusses Section 804 twice. The first instance, which plaintiffs conveniently presented only in part, states the following:

> *This section would set the statute of limitations in private securities fraud cases to the earlier of two years after the discovery of the facts constituting the violation or five years after such violation. The current statute of limitations for most private securities fraud cases is the earlier of three years from the date of the fraud or one year from the date of the discovery.* This provisions states that it is not meant to create any new private cause of action, but only to govern all the already existing private causes of action under the various federal securities laws that have been held to support private causes of action. This provision is intended to lengthen any statute of limitations under federal securities law, and to shorten none. The section, by its plain terms, applies to any and all cases filed after the effective date of the Act, regardless of when the underlying conduct occurred.

148 Cong. Rec. S7418-01, 7418 (italicized portion is part omitted by plaintiffs). Later in the Record, which plaintiffs failed to mention, Senator Leahy again emphasizes that Section 804 applies to securities *fraud* cases:

> Section 804 protects victims by extending the statute of limitations in private securities *fraud* cases. It would set the statute of limitations in private securities *fraud* cases to the earlier of five years after the date of the *fraud* or two years after the *fraud* was discovered. The current statute of limitations for most such *fraud* cases is three years from the date of the *fraud* or one year after discovery, which can unfairly limit recovery in some cases. It applies to all private securities *fraud* actions for which private causes of

> action are permitted and applies to any case filed after the date of the enactment, no matter when the conduct occurred.
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> . . .
>
> Especially in complex securities *fraud* cases, the current short statute of limitations may insulate the worst offenders from accountability. As Justices O'Connor and Kennedy said in their dissent in Lampf, Pleva. Lipkind, Prupis, & Petigrow v. Gilbertson, 111 S. Ct. 2773 (1991), the 5-4 decision upholding this short statute of limitations in most securities *fraud* cases, the current "one and three" limitations period makes securities fraud actions "all but a dead letter for injured investors who by no conceivable standard of fairness or practicality can be expected to file suit within three years after the violation occurred."
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> . . .
>
> It is time that the law is changed to give victims the time they need to prove their *fraud* cases.

Id. at 7419-20 (emphasis added). There is nothing in the legislative history to suggest that Congress had any intent to extend the limitations period for Section 11 claims – such claims *do not involve fraud.* 15 U.S.C. § 77k; *Schoenfeld v. Giant Stores Corp.*, 62 F.R.D. 348, 349-51 (S.D. N.Y. 1974) ("A suit under Section 11, however, is not akin to an action brought under the anti-fraud provisions of the securities law.").

Since the Sarbanes-Oxley Act did not change the limitations period for Section 11 claims and plaintiffs failed to plead that their claims fell within the one year/three year limitations period applicable to those claims, Counts III and IV (alleging Section 11 claims against Andersen) must be dismissed.

IV. PLAINTIFFS SHOULD NOT BE GRANTED LEAVE TO AMEND.

Apparently recognizing the danger that their Complaint may be dismissed, Plaintiffs request leave to amend, citing Fed. R. Civ. P. 15(a) for the proposition that leave to amend should be freely granted. But Rule 15(a) allows a party to amend "once" as a matter of course, Fed. R. Civ. P. 15(a), and Plaintiffs have already had that opportunity. A second amendment should be allowed only "when justice so requires." *Ibid. See also Denny v. Barber*, 576 F.2d 465, 471 (2d Cir. 1978) ("Plaintiff clearly has no right to a second amendment [under] Fed. R.

Civ. P. 15(a)"). Leave to replead should be denied where it would be a futile act. *Williams v. U.S. Postal Service*, 873 F.2d 1069, 1072 (7th Cir. 1989).

Plaintiffs fail to explain what new allegations they could make in a third pleading that could possibly state a valid cause of action against Andersen. Indeed, given that Plaintiffs' [Corrected] Amended Consolidated Complaint comprises 154 pages and contains 398 paragraphs, it is hard to imagine what more Plaintiffs could allege. Nor do Plaintiffs make any attempt to explain in their *two-sentence* argument requesting leave to amend how an amendment could cure the legal deficiencies of their claims, such as the failure to satisfy the pleading requirements of the PSLRA and the failure to file suit within the limitations period for a § 11 claim.

Moreover, the PSLRA's "high standard of pleading" would be "meaningless if judges on a case-by-case basis grant leave to amend numerous times." *Champion Enters. Sec. Litig.*, 145 F. Supp. 2d 871, 873 (E.D. Mich. 2001). Plaintiffs offer no valid reason to allow them yet another bite at the apple. The futility of still another amended complaint is confirmed by Plaintiffs' failure even to suggest what they would allege differently.

CONCLUSION

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

Dated: August 1, 2003

Respectfully Submitted,

ARTHUR ANDERSEN LLP

By: _____
One of the Attorneys for Arthur Andersen LLP

CERTIFICATE OF SERVICE

The undersigned, an attorney, hereby certifies that on August 1, 2003, I caused copies of the foregoing Arthur Andersen LLP's Corrected Reply Memorandum in Support of Motion to Dismiss the [Corrected] Amended Consolidated Class Action Complaint to be served upon the persons on the attached service list via overnight courier via hand delivery.

Susan Charles

SEE CASE FILE FOR EXHIBITS