

**UNITED STATES DISTRICT COURT  
NORTHERN DISTRICT OF ILLINOIS  
EASTERN DIVISION**

LAWRENCE E. JAFFE PENSION PLAN, On )	Lead Case No. 02-C-5893
Behalf of Itself and All Others Similarly )	(Consolidated)
Situated, )	
	) <u>CLASS ACTION</u>
Plaintiff, )	
	) Judge Ronald A. Guzman
vs. )	Magistrate Judge Nan R. Nolan
	)
HOUSEHOLD INTERNATIONAL, INC., et )	
al., )	
	)
Defendants. )	
_____ )	

**PLAINTIFFS' SUBMISSION PURSUANT TO THE COURT'S  
APRIL 17, 2009 STATEMENTS**

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## **I. INTRODUCTION**

Pursuant to the Court's instruction at the April 17, 2009 Jury Instruction Hearing, plaintiffs hereby submit additional authority and argument concerning defendants' duty to disclose the nature and existence of Household's predatory lending practices in the Company's Class Period Form 10-K and 10-Q Securities and Exchange Commission ("SEC") filings.

## **II. RELEVANT PROCEDURAL BACKGROUND**

On January 30, 2009, defendants moved to exclude the expert testimony of plaintiffs' accounting expert, Harris Devor, under *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993). On March 23, 2009, the Court granted defendants' motion in part. Specifically, the Court held Mr. Devor could not opine that "Household's financial statements for the class period falsely report its revenues because they include as revenue money obtained from predatory lending." *See* Dkt. No. 1528 at 2. The Court reasoned that "[a] determination that Household's lending practices were improper . . . would not make that money disappear or render Household's financial statements actionably false because money made from predatory lending is included in them."<sup>1</sup> *Id.*

In light of the Court's ruling, plaintiffs did not elicit testimony from Mr. Devor concerning his opinion that Household violated GAAP by booking revenue derived from the Company's predatory lending practices. However, Mr. Devor did testify that each of the Class Period 10-Ks and 10-Qs were false because the filings omitted and/or failed to disclose Household's predatory lending practices, an opinion contained in Mr. Devor's Rule 26 report and not challenged by defendants in their *Daubert* motion. April 15, 2009 Trial Tr. at 2416:7-2422:6. Defendants did not object to this

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<sup>1</sup> Even after the Court's ruling, plaintiffs were permitted to allege that Household's financial statements were false for other reasons. *See* Dkt. No. 1528 at 2 n.1 ("Plaintiffs may still argue that Household's financial statements are false for reasons other than the inclusion of money made from allegedly predatory lending practices.").

testimony. The Court subsequently expressed concern that Mr. Devor's testimony was simply a back door argument that Household's revenues were false because they were derived from illegal practices, in contravention of the Court's prior *Daubert* ruling. April 16, 2009 Trial Tr. at 2584:2:17.

At the April 17, 2009 Jury Instruction Hearing, the Court raised its concern with Mr. Devor's testimony again. *See* April 17, 2009 Hr'g Tr. at 2698:7-10. During the hearing, the Court expressed its inclination to instruct the jury that bare allegations concerning the falsity of Household's net income and EPS figures, absent any alleged statement concerning the source of those figures, did not trigger a duty in defendants to disclose Household's predatory lending practices. However, the Court encouraged plaintiffs to provide additional authority concerning defendants duty to disclose Household's predatory lending practices. This submission follows.

### **III. ARGUMENT**

#### **A. Because Household's Predatory Lending Practices Contributed to a Substantial and Material Amount of the Company's Net Income and EPS, Defendants Had a Duty to Disclose Such Practices**

Under the federal securities laws, omitted facts or information are material "only if a reasonable investor would have viewed the misrepresentation or omission as 'having significantly altered the total mix of information made available.'" *In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 400 (6th Cir. 1997) (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 232 (1988)); *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1332 (7th Cir. 1995) (same). However, "a corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact. Rather, an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts." *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993).

Here, the Court found that Household's predatory lending practices were clearly material to a reasonable investor. April 17, 2009 Hr'g Tr. at 2715:24-25 ("I mean, I'm not talking that [Household's predatory lending practices] is not material information. I think it's clearly material."). The question then becomes whether defendants had a duty to disclose the existence and nature of Household's predatory lending practices. While there may be no general duty to disclose illegal or unlawful practices, defendants had a duty to disclose Household's predatory lending practices because those practices contributed a material amount to Household's net income.

In *Greenfield v. Professional Care, Inc.*, plaintiffs alleged that defendants were engaged in a continuing scheme to defraud the state of New York's Medicaid program "by filing claims for services that were rendered by persons who lacked the necessary qualifications to be eligible for Medicaid reimbursement." *Greenfield v. Professional Care, Inc.*, 677 F. Supp. 110, 112 (E.D.N.Y. 1987). Plaintiffs alleged that as a result of defendants' scheme, Professional Care's ("PC") earnings reflected payments that were illegally obtained. Plaintiffs also alleged that the company's financial statements failed to disclose the existence of PC's Medicaid fraud. *Id.* The court found that defendants' omissions were "directly related to PC's earnings." The Court also noted that "[i]nformation going directly to the financial condition of the company falls squarely within the range of information for which there is a 'substantial likelihood that a reasonable shareholder would consider important . . . and, if true, *ought to have been disclosed* in order to render defendant's public statements concerning its financial condition not misleading." *Id.* at 113 (emphasis added).

As in *Greenfield*, Household's predatory lending practices related directly to the Company's net income. Indeed, during trial, Mr. Devor testified, based on company documents, that approximately \$3.2 billion of Household's Class Period net income was attributable to the Company's predatory lending practices during the relevant time period. *See* April 15, 2009 Trial Tr. at 2409:9-2410:9. In 1999, for example, 28.4% of Household's net income was attributable to its

predatory lending practices. In 2000, more than 32% of Household's net income was derived from the Company's predatory lending practices. In 2001, 36.2% of the Company's net income was attributable to Household's predatory lending practices. *See* Plaintiffs' Demonstrative No. 040. Mr. Devor further testified that the amounts attributable to predatory lending were material. April 15, 2009 Trial Tr. at 2416:7-14. Because the practices were clearly material to Household's net income, defendants had a duty to disclose those practices. *See also Peltz v. Polyphase Corp.*, 36 Fed. Appx. 316, 318 (9th Cir. 2002) (finding that defendant company's failure to disclose its loan problem raised a genuine issue of fact as to whether the financial disclosures were misleading and noting that defendant company should have disclosed that it was funneling money from the borrower).

Moreover, while *Sofamor Danek* and its progeny may constitute persuasive authority, the propositions set forth therein are not controlling Seventh Circuit law and are distinguishable from the present case. For example, the *Sofamor Danek* plaintiffs never challenged the accuracy of the company's sales and earnings data. *Sofamor*, 123 F.3d at 403. Similarly, in *Roeder v. Alpha Industries, Inc.*, plaintiffs claimed defendants violated the federal securities laws by failing to disclose that the company's president bribed a defense contractor in exchange for subcontracts. *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 24 (1st Cir. 1987). Although the court found defendants' illegal activity would likely be material investors, the court held that defendants had no affirmative duty to disclose the existence of defendants' illegal activity. *Id.* at 27. The plaintiffs in *Roeder*, however, failed to identify the existence of any inaccurate, incomplete, or misleading disclosures. *Id.* Here, plaintiffs have alleged from the inception of this case that defendants failed to disclose to the market that Household engaged in predatory lending practices and that Household's financial statements were inaccurate as a result.

In *Galati v. Commerce Bancorp, Inc.*, the Third Circuit affirmed the district court's dismissal of plaintiffs' securities fraud claim, holding that the company had no duty to disclose bid-rigging and

other unlawful practices. *Galati v. Commerce Bancorp, Inc.*, 220 Fed. Appx. 97, 102 (3d Cir. 2007). But the “malfeasance” alleged to have occurred in *Galati* was committed by three officers employed by one of the company’s subsidiaries. *Id.* Neither the parent corporation, nor any of the parent corporation’s officers were charged with criminal conduct. *Id.* at 100. Moreover, the illegal activity alleged in *Galati* contributed roughly \$51.5 million, compared to the company’s total growth of \$13.9 billion in 2002 and \$19.6 billion in 2003 – a negligible amount. *Id.* at 99-100.

Unlike in *Galati*, Household’s predatory lending practices were not the result of the “malfeasance” of three officers in a subsidiary of the company. Rather, Household’s deceptive lending practices were widespread, systemic and emanated from the CEO and President of Consumer Lending, Household’s largest business unit with receivables of \$39.5 billion out of approximately \$100 billion during the Class Period. Additionally, as discussed above, Household’s predatory lending practices contributed to 28.4% of Household’s net income in 1999, 32.6% in 2000, 36.2% in 2001 and 32.8% for the first quarter of 2002. Because of the materiality of Household’s predatory lending practices to its net income, defendants had a duty to disclose those practices.

**B. Each of Household’s Class Period 10-K and 10-Q Filings Stated Household’s Adherence to High Ethical Standards and Strong Growth, Thereby Triggering Defendants’ Duty to Disclose Household’s Predatory Lending Practices**

It is well-established that §10(b) liability can arise when defendants “know that statements putting the source of the company’s revenue at issue are false or misleading, even though the financials themselves are otherwise accurate.” *Steiner v. Medquist Inc.*, No. 04-5487 (JBS), 2006 U.S. Dist. LEXIS 71952, at \*48 (D.N.J. Sept. 29, 2006). That each of Household’s Class Period 10-Ks and 10-Qs put Household’s ethics and the source of the Company’s record growth squarely “into play” is without question. As a result, defendants had a duty to disclose Household’s predatory lending practices, but failed to do so. *Oran v. Stafford*, 226 F.3d 275, 285 (3d Cir. 2000) (“By addressing the quality of a particular management practice, a defendant declares the subject of its

representation to be material to the reasonable shareholder, and thus is bound to speak truthfully.’’)) (citation omitted); *In re Sotheby’s Holdings, Inc. Sec. Litig.*, 00 CIV. 1041 (DLC), 2000 U.S. Dist. LEXIS 12504, at \*13 (S.D.N.Y. Aug. 31, 2000) (“when a corporation does make a disclosure – whether it be voluntary or required – there is a duty to make it complete and accurate’’) (citation omitted).

During the Class Period, Household filed Form 10-Ks for years ended 1999, 2000 and 2001. At the April 17, 2009 hearing, the Court agreed that plaintiffs sufficiently identified language in Household’s 2000 and 2001 10-Ks that put Household’s deceptive lending practices at issue, thereby triggering defendants’ duty to disclose such practices. *See* April 17, 2009 Hr’g Tr. at 2716:10-2717:12 (“[W]hen you open that door, you better include all of the evidence that relates to it.”). Yet all three of the 10-Ks contained on plaintiffs’ false statement chart and alleged to be false and misleading contain the following, identical language:

Management has long recognized its responsibility for conducting the company’s affairs in a manner which is responsive to the interest of the employees, shareholders, investors and society in general. This responsibility is included in the statement of policy on ethical standards which provides that the company will fully comply with laws, rules and regulations of every community in which it operates and adhere to the highest ethical standards. Officers, employees and agents of the company are expected and directed to manage the business of the company with complete honesty, candor and integrity.

*See* Plaintiffs’ Trial Exhibit No. 1462, at 187; Defendants’ Trial Exhibit Nos. 851, 852. Because the Court has concluded defendants had a duty to disclose its predatory lending practices in Household’s 2000 and 2001 10-Ks, the Court should find that defendants had the same duty to disclose Household’s predatory lending practices in the Company’s 1999 10-K, as the 1999 10-K contains the same misleading statements.<sup>2</sup>

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<sup>2</sup> Household’s 1999 10-K also includes identical language as set forth in the 2000 10-K and found by the Court to give rise to defendants’ duty to disclose Household’s predatory lending practices: “Our focus is



Household also filed ten Form 10-Qs during the Class Period. In each of the 10-Qs, Household reported increased net income and EPS, attributed in part to Household's strong growth.

For example, in Household's 10-Q for the period ending June 30, 1999, Household reported:

Our net income for the second quarter of 1999 was \$326.9 million, compared to operating net income of \$249.4 million a year ago. Net income for the first six months of 1999 was \$647.7 million, compared to operating net income of \$488.7 million in the year ago period. Diluted earnings per share was \$.67 in the second quarter and \$1.32 for the first six months of 1999, compared to diluted operating earnings per share of \$.49 and \$.96 in the same periods in 1998. ***These improved results were due to strong growth in our consumer finance business*** and significant declines in operating expenses.

See Defs' Trial Exhibit 854 at HHT0015894 (emphasis added). Thus, in the very same paragraph in which Household reported its net income and EPS for the quarter (*i.e.* the financial information contained on plaintiffs' false statement chart),<sup>3</sup> Household attributed its "improved results" to the Company's ***strong growth***. Indeed, each of Household's Class Period 10-Qs contained identical or similar language. *See, e.g.*, Plaintiffs' Exhibit 735 ("Our net income for the first quarter of 2000 increased 16.2 percent to \$372.9 million . . . . Diluted earnings per share increased 20.0 percent to \$.78 in the first quarter . . . . Our improved results were due to strong revenue growth driven by significant receivables growth . . . .").<sup>4</sup>

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to use risk-based pricing and effective collection efforts for each loan. We have a process which we believe gives us a reasonable basis for predicting the asset quality of new accounts." Plaintiffs' Trial Ex. 1462 at 98.

<sup>3</sup> Thus, while plaintiffs' false statement chart gives the impression that Household's net income and EPS were reported independently, upon closer examination of Household's Class Period 10-Qs, it becomes clear that Household disclosed its financial figures in the same breath that it attributed its results to the Company's strong growth. Defendants should not be absolved of their duty to disclose Household's predatory lending practices merely because plaintiffs' false statement chart included only a fraction of the language set forth in Household's 10-Qs and 10-Ks. The statements, whether listed in the false statement chart or not, created a duty to disclose, and defendants' failure to disclose gave rise to the actionable omissions alleged by plaintiffs. *See* Pretrial Order, Exhibit B to Exhibit B-1 (Ex. 1 attached hereto) (setting forth plaintiffs' alleged omissions).

<sup>4</sup> Plaintiffs have attached (as Ex. 2 hereto) excerpts from Household's Class Period 10-Ks and 10-Qs, which highlight the applicable language concerning Household's "solid growth."

Each and every time Household reported net income and EPS during the Class Period, it attributed its results to the Company's "strong growth." By doing so, defendants put the source of Household's growth at issue. Once defendants undertook to make statements about Household's net income and growth, they had a duty to "speak truthfully and to make such additional disclosures as [were] necessary to avoid rendering the statements made misleading." *In re Par Pharm., Inc. Sec. Litig.*, 733 F. Supp. 668, 675 (S.D.N.Y. 1990) (concluding that a jury could find defendants' statements extolling Par's ability to obtain FDA approvals and comparing Par's success to other companies to be materially misleading to a reasonable investor). Defendants were obligated to "disclose information concerning the source of its success" – the Company's predatory lending practices – "since reasonable investors would find that such information would significantly alter the mix of available information." By omitting crucial information about the true source of Household's "strong growth," defendants violated their duty to disclose and should be subject to liability under the federal securities laws. *In re Van Der Moolen Holding N.V. Sec. Litig.*, 405 F. Supp. 2d 388, 401 (S.D.N.Y. 2005) (concluding that because defendants put the source of VDM Specialists revenue at issue, the failure to disclose the true sources of such revenue could give rise to liability under §10(b)) (citation omitted); *see also In re Providian Fin. Corp. Secs. Litig.*, 152 F. Supp. 2d 814 (E.D. Pa. 2001) (same); *Steiner*, 2006 U.S. Dist. LEXIS 71952, at \*53 (holding that statements putting the source of the company's revenue at issue were misleading, specifically where defendant failed to disclose its fraudulent billing scheme, instead attributing its revenue to legitimate business factors).

**C. Defendants' Failure to Disclose Household's Predatory Lending Practices in Company Earnings Press Releases Rendered Each Subsequently Filed 10-Q or 10-K False and Misleading**

Defendants also had a duty to disclose Household's predatory lending practices in the Company's Class Period 10-Qs and 10-Ks under the "duty to correct." Traditionally, a duty to correct "applies when a company makes a historical statement that, at the time made, the company

believed to be true, but as revealed by subsequently discovered information actually was not.” *Stransky*, 51 F.3d at 1331. The duty to correct must likewise apply where, as here, defendants knew that previously reported statements made in Household’s press releases were false and misleading, but subsequently repeated the same false statements. *See Gallagher v. Abbott Labs.*, 269 F.3d 806, 810 (7th Cir. 2001) (noting that where a financial statement falsely reports results, the company must “fix the error”).

During the Class Period, Household issued press releases reporting the Company’s net income and EPS for the quarter. Subsequently, Household filed its 10-Ks or 10-Qs, which repeated the same statements made in Household’s press releases. At the time Household filed its 10-Ks and 10-Qs, the false statements accompanying their earnings numbers remained in the market. When defendants repeated those earnings numbers, they had a duty to speak truthfully and completely as to correct their prior false statements.

#### **IV. CONCLUSION**

In sum, because Household’s predatory lending practices contributed to a significant and material portion of the Company’s net income, defendants had a duty to disclose such practices. Additionally, when Household reported net income and revenue while contemporaneously attributing its results to Household’s “strong growth,” Household put the source of that growth at issue, thereby triggering defendants’ duty to disclose Household’s predatory lending practices. Finally, defendants had a duty to correct the prior false statements set forth in Household’s earnings press releases when Household subsequently filed its 10-Ks and 10-Qs, which repeated the same misleading statements about the source of Household’s growth.

DATED: April 20, 2009

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on April 20, 2009, I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system which will send notification of such filing to the e-mail addresses denoted on the attached Electronic Mail Notice List, and I hereby certify that I have mailed the foregoing document or paper via the United States Postal Service to the non-CM/ECF participants indicated on the attached Manual Notice List.

I certify under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on April 20, 2009.

/s/ Michael J. Dowd

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