UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

IN RE WORLDCOM, INC. SECURITIES LITIGATION		MASTER FILE 02 Civ. 3288 (DLC)
This Document Relates to:		
02 Civ. 3288	02 Civ. 4990	02 Civ. 9514
02 Civ. 3416	02 Civ. 5057	02 Civ. 9515
02 Civ. 3419	02 Civ. 5071	02 Civ. 9516
02 Civ. 3508	02 Civ. 5087	02 Civ. 9519
02 Civ. 3537	02 Civ. 5108	02 Civ. 9521
02 Civ. 3647	02 Civ. 5224	02 Civ. 2841
02 Civ. 3750	02 Civ. 5285	02 Civ. 3592
02 Civ. 3771	02 Civ. 8226	03 Civ. 6229
02 Civ. 4719	02 Civ. 8228	03 Civ. 7298
02 Civ. 4945	02 Civ. 8229	03 Civ. 7299
02 Civ. 4946	02 Civ. 8230	
02 Civ. 4958	02 Civ. 8234	
02 Civ. 4973	02 Civ. 9513	

LEAD PLAINTIFF'S MEMORANDUM OF LAW IN OPPOSITION TO ARTHUR ANDERSEN LLP'S MOTION IN LIMINE TO EXCLUDE ANDERSEN'S UNRELATED CONVICTION AS WELL AS ITS CURRENT BUSINESS STATUS, AUDIT WORK FOR COMPANIES THAT HAVE BEEN OR ARE THE SUBJECT OF LITIGATION AND/OR FEDERAL OR STATE INVESTIGATION, AND SETTLEMENTS IN OTHER CASES

Lead Plaintiff hereby submits this memorandum of law in opposition to the Defendant Arthur Andersen LLP's motion in limine to exclude evidence of Andersen's felony conviction in the Enron scandal, as well as evidence of its current business status, audit work for companies that have been or are the subject of litigation and/or federal or state investigation, and Andersen's settlements in other cases (the "Motion").[1]

[1] The Underwriter-Related Defendants have also sought to exclude similar evidence. Lead Plaintiff hereby respectfully incorporates all of the arguments set forth in its opposition to that motion (Underwriter Defendants' Motion No. 7).

I. PRELIMINARY STATEMENT

Andersen's Motion should be denied. Evidence establishing the basic facts that a federal criminal investigation was being conducted involving Enron and that Andersen was indicted, and ultimately, convicted, of a felony in connection with that investigation, is essential to telling the jury the complete story of the discovery of the fraud at WorldCom. The existence of the Enron debacle and Andersen's prosecution for obstruction of justice played a central role in the actions resulting in the decision to replace Andersen as WorldCom's outside auditor and in the ultimate discovery of the fraud at WorldCom. The public disclosure of the fraud at Enron, as well as the criminal proceedings against Andersen arising from Andersen's own conduct, precipitated a change in direction and operation of WorldCom's Internal Audit Department. This scandal directly led the Internal Audit Department to add a financial dimension to its audits. The pending investigation and felony indictment of Andersen also inspired WorldCom to replace Andersen with a new auditing firm, KPMG, which confirmed the Internal Audit Department's suspicion that WorldCom's treatment of line costs was improper and caused a massive misstatement of the company's true financial statement. Together, these actions led to the discovery and revelation of the massive fraud involving capital expenditures.

Further, evidence relating to Andersen's involvement in engagements for other companies that proved to be involved in fraud is relevant to this case. This issue is fully addressed in Lead Plaintiff's Opposition Papers to the Underwriter Defendants' motion in this regard, and Lead Plaintiff will not restate them here. With respect to Andersen's current business condition, Lead Plaintiff does not presently intend to offer evidence in

this regard, but respectfully reserves the right to introduce such evidence in the event that defendants open the door on this topic.

ARGUMENT

II. EVIDENCE OF ANDERSEN'S PROSECUTION AND CONVICTION IN ENRON IS ADMISSIBLE UNDER THE FEDERAL RULES OF EVIDENCE AND APPLICABLE CASE LAW.

A. Evidence of Andersen's Prosecution and Conviction is Relevant to the Claims Presented by the Class and, Therefore, is Admissible Pursuant to Rule 401.

Evidence of Andersen's prosecution and conviction relating to Enron is admissible under Rule 401 because it is essential to explain the discovery of the fraud. *See* Fed.R.Evid. 401 ("All relevant evidence is admissible"). Three witnesses from WorldCom's Internal Audit Department – Cynthia Cooper, Eugene Morse and Glyn Smith – each testified that the Enron scandal, and Andersen's direct participation in the events resulting in its criminal prosecution, caused the Internal Audit Department to change the type of audits it conducted so that each audit would contain a financial component, rather than having the Internal Audit Department continue to perform purely "operational" audits. For example, Cooper testified that two of the factors that led the Internal Audit Department to make this shift were the Enron scandal and the fact that Andersen was indicted for its action in Enron. *See* Ex. H (Cooper Tr. at 310:20-311:25).[2] Similarly, Morse confirmed in his testimony that it was his understanding that Enron was the main driver behind Cooper's decision that, starting in 2002, each audit conducted by the Internal Audit Department would have a financial component. *See* Ex. K (Morse Tr.

[2] All exhibits referenced herein are attached to the Declaration of Jeffrey W. Golan, with Exhibits, in Support of Responses to the Motions of Arthur Andersen LLP to Exclude: (1) The SIC Report, Interview Memoranda, and the Bankruptcy Examiners Reports; (2) Reference to Any of its Liability Insurance; (3) Certain Testimony of Eugene Morse; (4) The KPMG Material Weakness Letter; and (5) Andersen's Unrelated Convictions as Well as its Current Business Status, Audit Work for Other Companies that Have Been or Are the Subject of Litigation and/or Federal or State Investigation, and Settlement in Other Cases.

at 147:1-147:3, 147:6-147:14); *see also* Ex. L (Smith Tr. at 137:7-138:5) (Smith testified that as a result of the Enron scandal and Andersen's prosecution, the Internal Audit Department's 2002 capital expenditure audit included a financial component).

This change in the direction of the Internal Audit Department, in turn, led to the rapid discovery of the fraud at WorldCom, with the first $500 million in line cost fraud being identified on the first day by Eugene Morse and Glyn Smith. *See* Ex. K (Morse Tr. at 22:13-23:1); Ex. H (Cooper Tr. at 111:11-112:2); Ex. L (Smith Tr. at 121:8-121:17 and 121:19-122:3). This evidence regarding the Enron scandal and Andersen's corresponding criminal prosecution is crucial to telling the complete story of the fraud at WorldCom.

The record also demonstrates that the prosecution of Andersen in Enron played a critical role in the replacement of Andersen by the new outside auditing firm, KPMG, which, in turn, subsequently confirmed the Internal Audit Department's discovery. Cooper testified that at the March 2002 audit committee meeting, WorldCom director and defendant Judith Areen expressed concern about continuing to use Andersen as the company's outside accounting firm because of Andersen's involvement in the Enron scandal. *See* Ex. H (Cooper Tr. at 316:5-316:21). Other former WorldCom directors also confirmed that their awareness of Andersen's involvement in the Enron affair led to the decision to replace Andersen as WorldCom's auditor. For example, Francesco Galesi testified that, as early as April 2002, WorldCom had begun discussions with KPMG to replace Andersen as WorldCom's auditors because of the problems stemming from the Enron debacle. *See* Ex. I (Galesi Tr. 456:13-456:19 and 459:7-459:14).

Andersen's own conduct demonstrated the interaction between the Enron and WorldCom matters. In fact, Andersen was so concerned about its involvement with the Enron scandal that, in February 2002, it made a presentation to the WorldCom Board of Directors entitled "*Andersen & Enron: Perception vs. Reality*." *See* Ex. F (8BRB: 209674-92). This reflected Andersen's own acknowledgement that its conduct in Enron was potentially relevant to judging its work for WorldCom.

In short, the evidence of Andersen's criminal prosecution and conviction in the Enron debacle is admissible to provide the jury with the complete story of what happened at WorldCom. Only by providing this information can the jury understand the events that led to the discovery of part of the fraud here and to KPMG replacing Andersen as its outside auditor. Thus, pursuant to Rule 401, evidence of Andersen's prior conviction is admissible.[3]

B. The Enron Related Prosecution and Conviction of Andersen Is Admissible for the Purposes Enumerated in Rule 404(b)

The prosecution and conviction of Andersen in connection with the Enron scandal is admissible for the purposes enumerated in Rule 404(b) of the Federal Rules of Evidence. Under Rule 404(b):

> Evidence of other crimes, wrongs or acts is not admissible to prove the character of a person to show action in conformity therewith. It may, however, be admissible for other purposes, such as proof of motive, opportunity, intent, preparation, plan, knowledge, identity or absence of mistake or accident . . .

(Emphasis added). The Second Circuit has adopted an "inclusionary approach'" to this Rule, under which "other acts evidence can be admitted 'for any purpose other than to

[3] The pendency of Andersen's appeal does not alter its admissibility. Fed.R.Evid. 609(e). *See also United States v. Aloi*, 511 F.2d 585, 596-97, *cert. denied*, 423 U.S. 1015 (2d Cir. 1975).

show a defendant's criminal propensity."' *United States v. Mitchell*, 328 F.3d 77, 82-83 (2d Cir. 2003) (quoting *United States v. Garcia*, 291 F.3d 127, 136 (2d Cir. 2002)) (emphasis added). The trial court's decision whether to admit such evidence is subject to an abuse of discretion standard, *Mitchell*, 328 F.3d at 83.

References to non-WorldCom events and litigation may be permissible in this action. Information concerning Andersen's role as Enron's auditor is a necessary component to the story about how the WorldCom fraud was discovered. Indeed, Arthur Andersen was replaced by KPMG directly as a result of Andersen's indictment. Ex. I (Galesi Tr. at 457). In May 2002, Cynthia Cooper, who was the head of Internal Audit, recommended that Internal Audit move up a scheduled audit of capital expenditures as a result of the events that had transpired at Enron and Andersen's role in those events, and for the first time include a financial statement component to the audit. See Ex. H (Cooper Tr. at 311-12); Ex. K (Morse Tr. at 82-83, 147); Ex. L (Smith Tr. at 137-38). In other words, for the first time, because of Enron, Internal Audit was going to attempt to verify what WorldCom's senior officers had been telling investors about WorldCom's capital expenditures.

Prior act evidence may be admitted under Rule 404(b) to inform the jury of the background of the claims, to complete the story, and to help explain to the jury how the improper relationships between the participants in the scheme developed. *See United States v. Inserra*, 34 F.3d 83, 90 (2d Cir. 1994); *see also United States v. Seffner*, 280 F.3 755, 764 (7th Cir. 2002) (acts satisfy Rule 404(b) "if they complete the story" of the claims on trial; "their absence would create a chronological or conceptual void in the story"; or they are "so blended or connected that they incidentally involve, explain, the

circumstances surrounding, or tend to prove any element of," the claim). Under this precedent, references to Andersen's role in the Enron affair, and how that led to the fraud at WorldCom being revealed, should be allowed "to complete the story" of the fraud at WorldCom. Indeed, Enron fills a significant gap to explain what distinguished Internal Audit's work beginning in May 2002 from its operational audits earlier in the Class Period, and refutes any suggestion by Defendants that Internal Audit's "failure" to uncover the fraud before May 2002 somehow absolves Defendants from their own due diligence failures. *Accord United States v. Arthur Andersen LLP*, No. H-02-121, 2002 U.S. Dist. LEXIS 26870, at *14 (S.D. Tex. 2002) ("The court concludes that the probative value of the Waste Management and Sunbeam [SEC enforcement actions against Andersen] is not substantially outweighed by the risk of undue prejudice… The Court is not persuaded that the jury will feel invited to convict Andersen for its prior SEC violations. Moreover, any prejudicial effect may be avoided by properly instructing the jury."). The prosecution and conviction of Andersen in connection with the Enron scandal is admissible for the purposes enumerated in Rule 404(b).

C. Under Rule 609(a)(2), Evidence of Arthur Andersen's Prior Conviction is Admissible to Impeach Arthur Andersen at Trial.

Andersen is also mistaken in arguing that under Rule 609 the evidence of its criminal conviction is inadmissible to impeach the testimony of the key Andersen personnel who were involved in the WorldCom audit.

First of all, Andersen is mistaken in suggesting that proof of its conviction is not admissible for the purpose of a challenge to its credibility. Rule 609(a)(2) provides that "For purpose of attacking the credibility of a witness, evidence that any witness has been convicted of a crime shall be admitted if it involved dishonesty or false statement,

regardless of the punishment." *See* Rule 609(a)(2) (emphasis added). Moreover, this court has previously held that a conviction for obstruction of justice can be introduced for impeachment purposes. *See United States v. Biaggi*, 705 F.Supp. 848 (S.D.N.Y. 1988) (under Rule 609, evidence of defendant's prior conviction for obstruction of justice could be introduced for impeachment purposes); *United States v. Rankin*, 1 F.Supp.2d 445, 455 (E.D. Pa. 1998), *aff'd*, 185 F.3d 863 (3d Cir. 1999) (pursuant to Rule 609(a)(2), conviction of obstruction of justice may subject a defendant to impeachment in future trials). Therefore, pursuant to Rule 609(a)(2) and applicable case law, evidence of Andersen's prior felony conviction for obstruction of justice should be admissible to impeach Andersen's credibility, which is directly at issue in this case.

Second, Andersen is mistaken when it contends that the evidence of its felony conviction should not be admissible to impeach the testimony of its representatives because these individuals, who had served as Andersen partners, managers or other employees working on the WorldCom engagement, were not themselves convicted of any criminal offense. Even the case law cited by Andersen is consistent with the use of an entity's criminal conviction when examining individuals associated with that entity. *Hickson Corp. v. Norfolk Southern Railway Co.*, 227 F.Supp.2d 903 (E.D. Tenn. 2002), which is followed by *Stone v. C.R. Bard, Inc.*, 02 Civ. 3433 (WHP), 2003 U.S. Dist. LEXIS 22035 (S.D.N.Y. December 8, 2003) – one of the two cases cited by Andersen and the only Court in this Circuit to discuss this issues – supports the admissibility of Andersen's prior conviction. In *Hickson*, the plaintiff sought to rebut a witness' testimony regarding the defendant's good environmental and safety record through evidence of the defendant's prior conviction of a felony for the improper disposal of

paint. *Hickson*, 227 F.Supp.2d at 903-905. The court reasoned that "[b]ecause a corporation speaks through its officers, *employees*, and other agents, however, it stands to reason a corporation can be a vicarious witness." *Hickson*, 227 F.Supp.2d at 907 (emphasis added). Therefore, the *Hickson* court concluded that "Rule 609 allows the use of a corporation's felony conviction to *impeach the corporation's vicarious testimony*." *Id.* (emphasis added). *Hickson* found the only other case cited by Andersen – *Walden v. Georgia-Pacific Corp.*, 126 F.3d 506 (3d Cir. 1997) – inapposite because "*Walden* … involved the use of a corporate conviction to impeach an employee – not the employee's employer. For this reason, the Court finds *Walden* inapropos." *Id.* The court's reasoning was bolstered by the fact that the witnesses' testimony regarding the defendant's environmental and safety record of the company and the defendant's clean-up efforts "*placed Norfolk Southern's credibility at issue*." *Hickson*, 227 F.Supp.2d at 908 (emphasis added). In addition, the court found that "speaking through its agents, Norfolk Southern told the jury the company had a good environmental and safety record." *Id.* Thus, because the court found that the corporation was really testifying as a vicarious witness through its representative and had placed its credibility at issue, the prior conviction was admissible to impeach the corporation.

Further, the court in *Hickson* stated, "Indeed, if the Court were to read *Walden* as broadly as Norfolk Southern [or Andersen] suggests – that is, standing for the proposition Rule 609 never applies to corporations because they cannot be actual witnesses – the self-professed credibility of a corporation for a particular character trait could never be impeached with evidence of past felonious malfeasance." 227 F.Supp.2d at 907, n. 5; *see also Stone*, *supra* at *11-*12 (testimony subject to impeachment because "Any other

result would permit Bard, through its agent Mirsky, to put its credibility at issue through testimony about its alleged stellar reputation in the industry, without any opportunity for plaintiffs to impeach that credibility"). *Walden* should not be given such an overbroad reading.

In *Stone v. C.R. Bard, Inc., supra,* the plaintiffs sought to introduce evidence of the company's criminal conviction during the cross-examination of one of the company's presidents. 2003 U.S. Dist. LEXIS 22035 at *5-6. Applying the principles discussed in *Walden and Hickson*, *Stone* reasoned that a witness is "a living embodiment" of the corporation in the eyes of the jury, and the testimony of the witness concerning the corporation's reputation in the industry for quality, integrity and service is fairly considered the testimony of corporation itself, and is therefore subject to impeachment by the corporation's prior felony convictions. *Stone* explained that "[a]ny other result would permit [the corporation], through its agent … to put its credibility at issue through testimony about its alleged stellar reputation in the industry, without any opportunity for plaintiffs to impeach that credibility." *Id.* at *11-*12. Accordingly, where plaintiffs' proposed use of the conviction was directed to impeach the reputation and credibility of the corporation, rather than the individual witness, the prior corporate conviction could be used against that witness to impeach the corporation's vicarious representations. *Id*. at *11.

Contrary to Andersen's contention, *Stone* did <u>not</u> "create an exception" to *Walden* "where the employee (i) testifies in the capacity of a corporate representative; and (ii) opens the door on the issues of the corporation's reputation for integrity and honesty." Motion at 5. Nothing in *Stone* or *Hickson* – which the Court in *Stone* found to be "more

persuasive" than *Walden* – hinges on the testimony stemming from a "corporate representative." In fact, *Hickson* makes clear that it is the testimony of a corporation's officer, *employee* or other agent that makes the corporation a vicarious witness and permits the introduction of a prior conviction. *Hickson*, 227 F.Supp.2d at 907, n.5 (emphasis added); *see also Stone*, 2003 Dist. LEXIS 22035, *10 (quoting *Hickson* for the proposition that when officers, agents or employees testify on behalf of the corporation, in reality it is the corporation testifying).

Andersen has informed the parties and the Court that it will be calling the following witnesses to testify live at trial: Kenneth Avery; Sam T. Block; Scott Clark; Melvin Dick; and Mark Schoppett. *See* Exhibit "D-2" to the Pretrial Order (Docket No. 2033). Presumably, these witnesses will testify — as former Andersen *partners and employees* — to the work they performed during the audits performed by Andersen and they will be the only witnesses called by the defendants to so testify because a corporation can only act through its representatives, employees and agents and cannot actually testify. In fact, Andersen asserts that the testifying witnesses are going to provide evidence that they acted in "good faith" in performing its audits and that those audits were performed in accordance with GAAS. *See* Motion at 8. This directly puts not only the witnesses' credibility at issue, but also Andersen's because the testifying witnesses were performing audits on WorldCom's financial statements on behalf of Andersen. *See Hickson*, 227 F.2d at 908 (agents' testimony informing the jury that the company had a good record placed the company's credibility at issue). Because Andersen has put its credibility at issue, plaintiffs should be permitted to impeach Andersen's credibility pursuant to *Stone* and *Hickson*.

Accordingly, pursuant to Rule 609(a)(2), the Court should find that evidence regarding Andersen's prior conviction shall be admissible.

C. Andersen Has Not Shown that it Will Suffer Any Unfair Prejudice that Substantially Outweighs the Probative Value of the Evidence to Warrant its Exclusion Under Rule 403.

Finally, Andersen offers a make weight argument that, even if relevant, the Court should preclude introduction of evidence of its criminal conviction because it will be unduly prejudicial. Motion at 5. This argument is predicated upon a misreading of both the test applied under Rule 403 and the relevance of this evidence here.

In order for evidence to be precluded under Rule 403, Andersen must show that its probative value is *substantially outweighed* by the danger of *unfair* prejudice, confusion of the issues, or misleading the jury. Where, as here, a party merely claims that it will be harmed but fails to demonstrate that the probative value is "substantially outweighed," the evidence is not excludable under Rule 403, because evidence is always harmful in some way to the opposing party. As Judge Scheindlin recently explained, "[o]f course, 'all evidence incriminating a defendant is, in one sense of the term, 'prejudicial' to him: that is, it does harm to him.' " *Lombardo v. Stone*, No. 99 Civ. 4603 (SAS), 2002 WL 113913 (S.D.N.Y. Jan. 29, 2002) (citing *Ismail v. Cohen*, 706 F.Supp. 243, 252 (S.D.N.Y. 1989), *aff'd in part*, 899 F.2d 193 (2d Cir. 1990)). "What 'prejudice' as used in Rule 403 means, is that the admission is, as the rule itself literally requires, 'unfair' rather than 'harmful.' " *United States v. Jimenez*, 789 F.2d 167, 171 (2d Cir. 1986).

Andersen has failed to demonstrate any "unfair" prejudice, confusion of the issues or the potential to mislead the jury. Andersen merely asserts that the evidence will incite emotions, confuse the issue of liability and mislead the jury to think that the same

individuals who worked on Enron also worked on WorldCom. On the contrary, the admission of this evidence is an essential part of the proof of the claims of the Plaintiff and the Class in this action. As explained above, evidence relating to Andersen's prosecution and conviction is both relevant and necessary to tell the complete story, as well as to impeach Andersen's witnesses. Moreover, there is no showing that a jury will be unable to understand simple facts, including that Andersen is on trial here for its conduct in this matter, not Enron, and that different Andersen partners and employees worked on each engagement.[4] The admission of this evidence of Andersen's indictment and conviction for its actions in Enron will not obscure these facts, while the exclusion of this evidence would fail to provide the jury with the complete picture concerning the discovery and confirmation of this massive fraud.

Accordingly, because Andersen has failed to demonstrate any unfair prejudice, let alone that the probative value of this evidence is substantially outweighed by any misplaced concern for confusion of the fact-finders, this Court should find that evidence regarding Andersen's indictment and conviction is not inadmissible under Rule 403.

[4] If necessary, the Court may always issue an appropriate instruction to the jury to avoid any confusion or misapplication of this evidence.

III. CONCLUSION

For the foregoing reasons, plaintiffs respectfully request that the Court rule that the evidence relating to Andersen's indictment and conviction is admissible at trial.

Dated: January 21, 2005

Respectfully submitted,

BERNSTEIN LITOWITZ BERGER & GROSSMANN LLP

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Max W. Berger (MB-5010)
John P. Coffey (JC-3832)
Steven B. Singer (SS-5212)
Chad Johnson (CJ-3395)
J. Erik Sandstedt (JS-9148)
Beata Gocyk-Farber (BGF-5420)
Jennifer L. Edlind (JE-9138)
John C. Browne (JB-0391)
David R. Hassel (DH-0113)
1285 Avenue of the Americas
New York, NY 10019-6028
Tel: (212) 554-1400

-and-

BARRACK, RODOS & BACINE

_____

Leonard Barrack
Gerald J. Rodos
Jeffrey W. Golan
Mark R. Rosen
Jeffrey A. Barrack
Pearlette V. Toussant
Regina M. Calcaterra (RC-3858)
Chad A. Carder
3300 Two Commerce Square
2001 Market Street
Philadelphia, PA 19103
Tel: (215) 963-0600

Attorneys for Lead Plaintiff Alan G. Hevesi, Comptroller of the State of New York, as

Administrative Head of New York State and Local Retirement Systems and as Trustee of the New York State Common Retirement Fund, and Co-Lead Counsel for the Class

BERMAN, DEVALERIO, PEASE TABACCO, BURT & PUCILLO
Joseph J. Tabacco, Jr. (JT-1994)
425 California Street, Suite 2025
San Francisco, CA 94104
Tel: (415) 433-3200
-and-
Michael J. Pucillo
515 North Flagler Drive, Suite 1701
West Palm Beach, FL 33401
Tel: (561) 835-9400
-and-
Glen DeValerio
Kathleen M. Donovan-Maher
Joseph C. Merschman
One Liberty Square
Boston, MA 02109
Tel: (617) 542-8300

Attorneys for Additional Named Plaintiffs Fresno County Employees Retirement Association and the County of Fresno, California

SCHOENGOLD, SPORN, LAITMAN & LOMETTI, P.C.
Samuel P. Sporn (SS-4444)
Christopher Lometti (CL-9124)
Ashley Kim (AK-0105)
19 Fulton Street, Suite 406
New York, NY 10038
Tel: (212) 661-1100

Attorneys for Additional Named Plaintiff HGK Asset Management, Inc.