

**UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK**

IN RE WORLDCOM, INC. SECURITIES :
LITIGATION : MASTER FILE
 : 02 Civ. 3288 (DLC)

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**LEAD PLAINTIFF’S MEMORANDUM OF LAW IN RESPONSE
TO THE MOTION OF ARTHUR ANDERSEN LLP
TO EXCLUDE KPMG’S MATERIAL WEAKNESS LETTER**

Lead Plaintiff submits this memorandum in opposition to the motion of Arthur Andersen LLP (“Andersen”) to exclude the June 3, 2003 letter from KPMG to WorldCom’s Audit Committee concerning material weaknesses that KPMG determined existed at the Company during the relevant time period up through and including March of 2003 (the “Letter”).¹

¹ Andersen’s motion seeks to exclude General Binder 22, which Andersen has designated as “KPMG’s 241-Page Material Weakness Binder.” Lead Plaintiff opposes Andersen’s motion in its entirety to the extent that it seeks to exclude the actual letter provided by KPMG (a 54-page letter of June 3, 2003). See Ex. M at 2KPMG300660006-59; see also Ex. C (June 3, 2003 Form 8-K at Exhibit 99.1) (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 Bankruptcy Examiner’s 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.) To the extent Andersen seeks exclusion of KPMG’s workpapers supporting the Letter (Ex. M at 2KPMG300660060-

Andersen claims that the Letter is not relevant, constitutes inadmissible hearsay, and that the “unfair prejudice” caused by its admission is substantially greater than its probative value. For the reasons stated herein, Andersen’s motion to exclude this evidence should be denied.

BACKGROUND

On June 3, 2003, KPMG, as part of its re-audits of the years ended December 31, 2000, and 2001, and of its initial audit of the year ended December 31, 2002, issued the Letter to the Company’s Audit Committee. The Letter set forth various material weaknesses that KPMG discovered during its work on the 2000, 2001 and 2002 audits, as well as other, additional issues identified in KPMG’s concurrent consideration of Sarbanes-Oxley Section 404, other internal control matters and certain matters specific to the Company’s accounting, all of which were communicated to WorldCom’s audit committee in June 2003. *See* Ex. C (June 3, 2003 Form 8-K); Ex. M (2KPMG300660060-242). The Letter is a recommendation letter to WorldCom’s management from its auditor (KPMG), with management’s responses. WorldCom provided the Letter to the Securities and Exchange Commission (“SEC”), to Richard C. Breeden, the Corporate Monitor appointed by the U.S. District Court for the Southern District of New York with the consent of the SEC and WorldCom, and to Richard Thornburgh, the Examiner appointed by U.S. Bankruptcy Court for the Southern District of New York (the “Bankruptcy Court”), in connection with numerous proceedings arising from the WorldCom debacle. Ex. D (June 9, 2003 Form 8-K at 2).

The Letter was drafted carefully and with the intent that it would be relied upon. As set forth herein, the Letter is relevant to the facts and events that occurred during the Class Period, it was prepared in the ordinary course of business, it has all the hallmarks of reliability, and it is

242), Lead Plaintiff opposes that portion of the motion but only for the purpose of ensuring that Lead Plaintiff’s accounting and auditing expert may be permitted to rely upon those workpapers at trial. Fed. R. Evid. 703.

furthermore probative for a variety of non-hearsay purposes, such as an showing an alternative to Andersen's approach for communicating with, and obtaining responses from, the Company's management about the establishment and maintenance of necessary controls to ensure the accuracy of the Company's financial reporting. The Letter's probative value far outweighs any claim of unfair prejudice.

ARGUMENT

1. The Letter is Relevant

The Letter is relevant because it establishes facts underlying Lead Plaintiff's claims in this case. Fed.R.Evid. 401, 402. The Letter is highly relevant, among other reasons, because it tends to establish that (1) WorldCom and Andersen failed to properly assess whether impairment charges should have been booked in fiscal years 2000 and 2001, (2) there were inadequate controls during the Class Period, and (3) Class Period communications between Andersen and WorldCom management were woefully inadequate, thereby impacting the ability of Andersen to conduct GAAS-compliant audits. As we show below, Andersen's counter-arguments that the Letter is not relevant because it was written after the Class Period, and that the internal control weaknesses discussed in the Letter are not indicative of conditions that existed during time Andersen conducted its audits, are without merit.

In the Letter, KPMG enumerated nearly thirty material weaknesses that it had discovered when it worked on re-auditing the financial statements for the years ended December 31, 2000, and 2001, and on its audit for the year ended December 31, 2002. Among those weaknesses identified by KPMG were a number of issues that Andersen failed to recognize that directly relate to the fraudulent activity perpetrated in this matter, including, but not limited to:

- The Company needs to implement procedures and controls to review, monitor and maintain general ledger accounts. Exs. M, C (2KPMG300660015; Ex. 99.1 to June 9, 2003 Form 8-K at p.10 of 54).
- The Company must implement procedures to ensure the reconciliations between subsidiary ledgers and the general ledger are performed. *Id.* (2KPMG300660017; p.12 of 54).
- Significant improvement needs to be made in segregation of duties, responsibilities and management review controls. *Id.* (2KPMG300660025; p.20 of 54).
- Policies, procedures and standardization of internal controls need to be implemented. *Id.* (2KPMG300660027; p.22 of 54).
- The Company's operating management must be provided with appropriate financial information and appropriate procedures must be in place such that the Company's operating management is confident that financial information being used to manage their businesses is ultimately included in the Company's externally reported financial information. *Id.* (2KPMG300660027; p.22 of 54).
- Sufficient analysis and documentation of non-routine transactions needs to occur. For prior years, the Company could not provide supporting documentation regarding its assessment of Statement of Financial Accounting Standards (SFAS) No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of. *Id.* (2KPMG300660030-31; p.25-26 of 54).

Thus, the Letter is relevant, because, at the very least, it tends to prove that WorldCom and Andersen failed to ensure that impairment analyses were performed, and that these types of important controls were still lacking during the time of KPMG's audits of WorldCom's financial statements for the years 2000 through 2002.

The Letter further tends to show differences between the conclusions of Andersen and KPMG concerning the same set of facts, including an assessment of WorldCom's processes relating to the consideration of the carrying value of tangible and intangible assets in accordance with FAS No. 121. For example, KPMG noted:

We were also informed that management had not performed an impairment analysis of its long-lived assets nor could we find documentation as to where impairment was considered or analysis performed.

See Exs. M, C (2KPMG300660030; Ex 99.1 to June 9, 2003 Form 8-K at p.25 of 54). This determination relates to the years ended December 31, 2000, and 2001, and stands in sharp contrast to Andersen’s failure to ensure that the impairment analyses were performed by the Company.

Indeed, in its summary judgment motion papers, Andersen admitted that it was not aware of inadequate controls at the Company. *See* Andersen’s Mem. in Support of Motion for Summary Judgment at 38 (Docket No. 1504). Given the fact that Andersen claims to have conducted a controls-based “business” audit, a jury is entitled to consider this evidence concerning KPMG’s identification and evaluations of the Company’s controls. At the very least, the Letter is relevant in this regard to show how another leading auditing firm, KPMG, conducts and evaluates a company’s internal controls. Indeed, the Letter could be significant evidence tending to demonstrate Andersen’s recklessness because it stands in sharp contrast to the conduct of Andersen’s engagement team insofar as they complained that the Company’s internal auditors continued to raise questions about weaknesses in controls even where Andersen had not. *See* Ex. H (Cooper Tr. at 312:14-313:9). As Ms. Cooper testified:

Kenny Avery indicated that the engagement partner was concerned because internal audit was continuing to bring so many internal control recommendations to the attention of the audit committee and Andersen was not bringing any.

Id. at 322:16-323:5. For these reasons, the Letter is clearly relevant.

2. The Letter is Admissible As a Business Record

The Letter is admissible pursuant to Rule 803(6) of the Federal Rules of Evidence because it is a business record. Rule 803(6) of the Federal Rules of Evidence provides for the admission of business records created in the regular course of business activities.² In the Second

² Rule 803(6) states, in pertinent part: “A memorandum, report, record or data compilation, in any form, of acts, events, conditions, opinions or diagnoses, made at or near the time by, or from information transmitted by, a person

Circuit the “principal precondition to admission of documents as business records pursuant to Fed. R. Evid. 803(6) is that the records have sufficient indicia of trustworthiness to be considered reliable.” *American Equities Group, Inc. v. Ahava Dairy Products Corp.*, 2004 WL 870260, No. 01 Civ. 5207, at *9 (April 23, 2004 S.D.N.Y.) (quoting *Potamkin Cadillac Corp. v. B.R.I. Coverage Corp.*, 38 F.3d 627, 632 (2nd Cir. 1994)); *In re: Blech Securities Litigation*, 2003 WL 1610775, at *5 (S.D.N.Y. March 26, 2003). Information is considered to be reliable and trustworthy where there is a business duty to report or verify the recorded information. *United States v. Reyes*, 157 F.3d 949, 952 (2nd Cir. 1998). Rule 803(6) “favors the admission of evidence rather than its exclusion if it has any probative value at all.” *United States v. Williams*, 205 F.3d 23, 34 (2nd Cir.), *cert denied*, 531 U.S. 885 (2000).

Here, the Letter itself evidences its admissibility under the Rule. As KPMG wrote to WorldCom’s Audit Committee:

We have been engaged to perform an audit of the consolidated financial statements of WorldCom, Inc. and subsidiaries (collectively referred to as “WorldCom”) for the years ended December 31, 2000, 2001 and 2002. While planning and performing our audits of the consolidated financial statements of WorldCom, we are considering internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements. ... In performing our work through March 6, 2003, we noted certain matters involving internal control and its operation that we consider to be reportable conditions under standards established by the America Institute of Certified Public Accountants. Reportable conditions are matters coming to our attention that, in our judgment, relate to significant deficiencies in the design or operation of internal control and could adversely affect the organization’s ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. ... A material weakness is a reportable condition in which the design or operation of one or more internal control components does not reduce to a relatively low level the risk that errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees

with knowledge, if kept in the course of a regularly conducted business activity, and if it was the regular practice of that business activity to make the memorandum, report, record, or data compilation, all as shown by the testimony of the custodian or other qualified witness... unless the source of information or the method or circumstances of preparation lack indicia of trustworthiness.”

in the normal course of performing their assigned functions. ... These matters were discussed with the Audit Committee on March 6, 2003. ... These matters were considered in determining the nature, timing and extent of the audit tests that we have planned and will be applying in our audits of the 2000, 2001 and 2002 consolidated financial statements.

See Exs. M, C (2KPMG300660007-7; Exhibit 99.1 to June 3, 2003 Form 8-K at pp.1-2 of 54).

The Letter describes conditions at or near the time KPMG conducted its assessment of WorldCom's 2000 and 2001 financial statements. KPMG had vast knowledge stemming from the lengthy work it had been performing in connection with those financial statements. Indeed, the Letter reflected KPMG's regular planning for an audit. As the KPMG's Audit Partner, Farrell Malone, testified:

Q. Is it part of KPMG's normal auditing procedure to consider an issuer's internal controls in order to determine the extent of its audit procedures?

A. Yes.

Q. And is it KPMG's normal practice to communicate reportable conditions to a company as they come to your attention?

A. Yes.

Q. And in what form do you report those normally?

A. We would typically report those to management in a letter to the audit committee, typically, or management, often referred to as a management letter on internal control.

Ex. J (Malone Tr. at 744:5-19); *see also id.* at 610:17-612:3 ("Certainly, as part of an audit, you would be required to review internal controls to the extent necessary to plan and carry out your audit and determine the audit procedures that need to be done.").

Indeed, it is well established that auditors will provide letters to management in the course of, as well as the conclusion of, audits for the purpose of advising companies, *inter alia*, of material weaknesses in their internal controls. Thus, the KPMG Letter is just the type of

report that is done within the normal course of an auditor's work. As such, it is within the kind of material that Rule 803(6) contemplates as admissible. *Reyes*, 157 F.3d at 952. And any doubts as to its reliability, or its applicability to the claims against Andersen and others in this case, would go to the weight that the jury may ascribe to the Letter, and not its admissibility. *Id.* at 953. As a result, the Letter should be admitted as a business record. *Williams*, 205 F.3d at 34.³

3. The Letter is Also Admissible for Non-Hearsay Purposes

Regardless of whether the statements in the Letter are true, the Letter tends to prove Lead Plaintiff's case. For example, the Letter may be considered by a jury as showing an alternative to Andersen's approach for communicating with the Company's management. It further provides an example of an alternative to Andersen's approach for obtaining responses from management on issues that impact establishment and maintenance of the controls necessary in financial reporting. Thus, the relevancy of the Letter also attaches to the fact that the Letter was sent, and required management responses, rather than the truth of the statements within it. It is, in utterance and consequence, a verbal act. *See McCormick on Evidence* § 249, at 732-33 (3d ed. 1984); *see also, e.g., New Era Publications Intern., ApS v. Henry Holt and Co., Inc.*, 873 F.2d 576, 592 (2d Cir. 1989); *United States v. Alvarez-Porras*, 643 F.2d 54, 58 (2d Cir.), *cert denied*, 454 U.S. 839 (1981).

³ The cases cited by Andersen are inapposite because, as demonstrated, the Letter is a routinely created KPMG business record. The cases favoring admissibility of such records also refer to Second Circuit jurisprudence, citing 4 J. Weinstein and M. Berger, Weinstein's Evidence § 803(6)[03], at 803-182, for the proposition that:

Since Congress did not intend to make the business record exception more restrictive than it had previously been, Rule 803(6) should be interpreted so that the absence of routineness without more is not sufficiently significant to require exclusion of the record. Nonroutine records made in the course of a regularly conducted "business" should be admissible if they meet the other requirements of Rule 803(6) unless "the sources of information or other circumstances indicate a lack of trustworthiness."

See also United States v. Prevatt, 526 F.2d 400, 403 (5th Cir.1976); *Magnus Petroleum Co. v. Skelly Oil Co.*, 446 F.Supp. 874, 882-83 (E.D.Wisc.1978), *rev'd*, 599 F.2d 196 (7th Cir. 1979).

The Letter may also be probative of the effect it had upon management, as indicated in management's responses to KPMG's recommendations concerning the Company's controls. *See, e.g., United States v. Press*, 336 F.2d 1003, 1011 (2d Cir. 1964), *cert. denied*, 379 U.S. 965 (1965) (citing Wigmore, Evidence §§ 1361, 1789 (3d ed. 1940); McCormick, Evidence § 225 (1954)). Finally, the Letter is admissible to show that an auditor could have had sufficient control over its own audit planning processes so as to identify material weaknesses at WorldCom, rebutting any argument from Andersen that is simply could not have uncovered the weaknesses identified by KPMG. *See, e.g., Karlson v. 305 East 43rd St. Corp.*, 370 F.2d 467, 472 (2d Cir.), *cert denied* 387 U.S. 905 (1967).

The Letter is therefore admissible for these additional non-hearsay purposes to show (1) the contrast of this Letter to WorldCom management with the lack of any similar correspondence between Andersen and WorldCom management or its Board during the Class Period; and (2) an effective control utilized by KPMG – but not Andersen – in connection with its audit planning.

4. The Probative Value of the Letter Outweighs any Unfair Prejudice

Pursuant to Rule 403, the probative value of the Letter outweighs any “*unfair*” prejudice that Andersen asserts might arise from its introduction. Rule 403 of the Federal Rules of Evidence permits a court to exclude relevant evidence only if its probative value is substantially outweighed by the risk of unfair prejudice or jury confusion. *George v. Celotex Corp.*, 914 F.2d 26, 30-31 (2d Cir. 1990). As the Court of Appeals has held, “[b]ecause Rule 403 permits the exclusion of probative evidence, it is an extraordinary remedy that must be used sparingly.” *Id.* at 31. Here, Andersen is simply seeking to exclude evidence that is adverse to its positions, which is not the prejudice that Rule 403 seeks to prevent. *See Dollar v. Long Mfg., N.C., Inc.*, 561 F.2d 613, 618 (5th Cir. 1977). “‘Unfair prejudice’ as used in Rule 403 is not to be equated

with testimony simply adverse to the opposing party. Virtually all evidence is prejudicial or it isn't material. The prejudice must be 'unfair.'" *Id.* Here, there is no "unfair" prejudice associated with admission of the Letter and there is substantial probative value. It should be admitted.⁴

CONCLUSION

For the foregoing reasons, Plaintiffs respectfully submit that Andersen's motion to exclude the June 3, 2003 letter from KPMG to WorldCom's Audit Committee concerning material weaknesses that KPMG determined existed at the Company during the relevant time period should be denied.

Dated: January 21, 2005

Respectfully submitted,

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⁴ The two cases cited by Andersen are inapposite given the circumstances of this case because the evidence cited therein had little, if any, probative value. Thus, the threshold was very low in terms of the prejudice that the party seeking to exclude the evidence was required to show.

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