UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

IN RE WORLDCOM, INC. SECURITIES LITIGATION

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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 EVIDENCE OF THE RESTATEMENT

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PRELIMINARY STATEMENT

Lead Plaintiff submits this memorandum in opposition to the motion of Arthur Andersen LLP ("Andersen") to exclude evidence relating to the restatement issued by WorldCom, Inc. ("WorldCom") of its financial statements for the years 2000 and 2001.

Andersen presents lots of bluster to support its motion, but no persuasive legal argument that overcomes the principle stated in Federal Rule of Evidence 402 that "all relevant evidence is admissible." "'Relevant evidence' means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." Fed. R. Evid. 401 (emphasis added).

Here, Plaintiffs assert that (a) the financial statements issued during the Class Period by WorldCom for the years 1999, 2000 and 2001, for which Andersen provided "clean" audit opinion letters, were materially false and misleading, and not in accordance with Generally Accepted Accounting Principles ("GAAP"), and (b) with respect to the Andersen audits, Andersen failed to conduct its audits for these year-end financial statements in accordance with Generally Accepted Auditing Standards ("GAAS"). Andersen and the Underwriter Defendants assert that (a) WorldCom's financial statements for the years 1999 and 2000 were not false or misleading, and were in accord with GAAP, and (b) WorldCom's 2001 financial statements, while overstated based on a $3 billion improper capitalization of line costs, were not materially overstated based on a $7 billion goodwill write-down and certain other adjustments that Plaintiffs contend were necessary to make the 2001 financial statements accurate at the time they were issued. Andersen further asserts that (c) its audits were performed in accordance with GAAS.

The Restatement issued by WorldCom, which was filed with the Securities and Exchange Commission on March 12, 2004, as part of the Company's Form 10-K for its year-end 2002

financial statements, goes to the heart of the disputes concerning whether the 1999, 2000 and 2001 financial statements were materially overstated for the reasons cited by Plaintiffs. It states that WorldCom's net income was overstated by $74 billion during the years 2000 and 2001 alone (compared to the $3 billion that Andersen concedes was overstated only for the year 2001). See Form 10-K for the year ended December 31, 2002 (Exhibit A), at 42.[1] It states, *inter alia,* that $59.2 billion of the overstatements resulted from errors in the amounts stated in WorldCom's initially issued financial statements as goodwill ($47.2 billion in 2000, and $12.6 billion in 2001); $5.8 billion from purchase accounting errors; and $4.7 billion from improper reduction of line costs. *Id*. Further, while the Restatement does not formally restate the Company's 1999 financial statements, it recognizes expressly that the financial statements before 2000 had also been misstated. *Id*. at 41 ("We have also restated the January 1, 2000 opening retained earnings balance to reflect corrected items that relate to prior periods."); Malone Tr. (Exhibit L) 547:4-548:6, 548:21-550:5 (listing categories within pre-2000 financial statements that were also overstated, and explaining that the Restatement does evidence certain changes that WorldCom made with respect to its 1999 financial statements, which changes are reflected in the restated opening balance utilized for the 2000 financial statements). Indeed, as Mr. Malone further explained, it was only because the SEC required the Company to restate just the two years of its financial statements that pre-dated 2002, that the Company did not also formally restate its financial statements for 1999. Malone Tr. at 548:7-12.

The Restatement was the result of an intensive investigation conducted by countless WorldCom employees, supported by consultants from at least four outside entities. Renna Tr. (Exhibit N) 30:10-22, 31:8-19, 37:3-22, 257:17-258:17. It was approved by the Audit

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[1] The Exhibits referred to herein are attached to the Declaration of Jeffrey W. Golan, With Exhibits, in Response to the Motion of Arthur Andersen to Exclude Evidence of the Restatement, which is also being filed this day.

Committee and Board of Directors of WorldCom prior to its filing with the SEC, and it was audited by KPMG, Inc. ("KPMG"), the outside accounting firm retained by WorldCom to serve as its outside auditor in the spring of 2002 in place of Andersen. Renna Tr. 30:10-13, 161:20-25; Passauer Tr. (Exhibit M) 191:23-25; *see also* WorldCom, Inc. Press Release, dated May 15, 2002 (Exhibit S).

Clearly, WorldCom's admission that its prior financial statements were false and misleading when issued, and the filing of its Form 10-K with the SEC that contains a description of the errors in the prior financial statements and amounts by which those financial statements were overstated, are relevant to the jury's determination of a key point of dispute in this case, that is, whether and by what amounts WorldCom's financial statements issued during the Class Period were materially false and misleading. While Andersen raises many contentions concerning the conclusions of the Restatement, and the methods by which its constituent parts were calculated, the Restatement nevertheless constitutes admissible evidence that has a "tendency" to make the existence of these facts more probable. As more fully discussed below, it is a business record that should be admitted pursuant to Rule 803(6) of the Federal Rules of Evidence. It also provides a relevant fact that Plaintiffs' accounting expert was entitled to consider, and rely upon when he deemed it appropriate to do so, pursuant to Rule 703. Further, the Restatement and testimony from WorldCom and KPMG witnesses about the Restatement should not be disallowed because of the "prejudice" that Andersen claims it will suffer from their introduction at the trial Indeed, were the Court to grant Andersen's motion, it is Plaintiffs who would suffer undue prejudice, and failing to admit the Restatement and testimony concerning it would further lead to jury confusion and an incomplete story about the WorldCom debacle being presented to the jury.

Incredibly, although Andersen was granted permission to file a 50-page brief (and actually filed a brief of 42 pages, supplemented by 25 pages of additional argument pertaining to different accounting arguments made in the brief), Andersen never addresses the key point that it is contesting the Plaintiffs' factual contention that WorldCom's financial statements were false. While harping on the issue on whether Andersen's audits complied with GAAS, *see, e.g.,* Andersen Br. at 2 (citing audit work as "central issue" in the case), Andersen virtually ignores that it continues to dispute the falsity of the WorldCom financial statements issued during the Class Period. Moreover, in its legal argument, Andersen fails to cite the one federal court decision ruling on a party's motion in a civil case to exclude a company's restatement, which decision is entirely on point with the present case, and decisively rejects each of the legal arguments made by Andersen in support of its motion.

The decision that Andersen fails to cite arose from an enforcement action brought by the SEC against various former executives of Sunbeam Corporation. *See SEC v. Uzzi*, 2003 U.S. Dist. LEXIS 15608 (S.D. Fla. Jan. 21, 2003) (Exhibit B hereto). Sunbeam was accused of issuing false financial statements, filed for protection under the bankruptcy laws, and issued restated financial statements. The SEC entered into consent decrees with certain former Sunbeam executives, but continued its enforcement action against Donald Uzzi, a former Executive Vice President of Sunbeam. *Id.* at *4. Uzzi filed a motion *in limine* to exclude the admission of Sunbeam's restatement at trial, raising many of the same issues that Andersen raises here. Judge Middlebrooks rejected each of the defendant's arguments, and allowed the company's restatement to be introduced at trial, as follows:

> Uzzi claims the Restatement and Report are not relevant to the SEC's case. Notwithstanding the fact Federal Rule of Evidence 401 provides an expansive definition of relevance, this evidence is highly relevant to the SEC's claim that misstatements or omission of material fact were made by Defendant. … Finally, the Restatement and Report are admissible against Uzzi under Federal Rule of Evidence 803(6) as business records and are

not excludable hearsay. These types of reports are filed by companies as a matter of course when such occurrences arise and fit squarely within the language of the exception in Rule 803(6).

SEC v. Uzzi, 2003 U.S. Dist. LEXIS 15608 at *5 (emphasis added) (footnote omitted).[2] [3]

ARGUMENT

Andersen has moved to exclude the Restatement under several Federal Rules of Evidence, but provides little analysis to support its contentions under each Rule. Andersen instead devotes a substantial amount of its brief (a) to convince the Court that Plaintiffs have said the Restatement is not necessary or that they will not be prejudiced by its exclusion, and (b) to discredit the Restatement and the methodologies that WorldCom utilized in calculating the prior errors. The first tack Andersen takes is entirely misguided given that the colloquy cited by Andersen took place less than two weeks after the Restatement was issued, in the context of a

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[2] The court also rejected Uzzi's arguments that the restatement should be excluded (a) as unduly prejudicial under Rule 403, and (b) as a subsequent remedial measure under Rule 407. The court found that exclusion under the "extraordinary remedy" of Rule 403 was not warranted, and that Rule 407 was inapplicable. As the Court held with respect to the latter argument: "Contrary to Uzzi's claims, Federal Rule of Evidence 407 barring admission of subsequent remedial measures does not serve to exclude the material at issue here. The Restatement and Report were not at all voluntary, and thus, neither the intent nor the policy underlying Rule 407 support exclusion of this material." Id. While Andersen does not make a Rule 407 argument here, the *Uzzi* court's finding that a restatement is not voluntary when a company concludes that its financial statements, as issued, were false is also relevant to the finding that a restatement is a business record as something a company is required to file with the SEC in the circumstances here.

Notably, the issue of the admissibility of the Sunbeam restatement had also been briefed in a securities class action that was pending against Andersen before a settlement of the class' claims against Andersen. *See In re Sunbeam Sec. Litig.*, No. 98-8256-Civ-Middlebrooks (S.D. Fla.). There, plaintiffs identified the restatement and work papers underlying the restatement as trial exhibits; Andersen and two former Sunbeam executives and directors, Dunlap and Kersh, moved to exclude reference to the restatement. Plaintiffs opposed the motion, and the SEC filed an *amicus* brief in support of admission of the restatement in the class action. *See* Brief of United States Securities and Exchange Commission as Amicus Curiae Regarding Defendants' Motions In Limine to Exclude Evidence of the Restatement and Restatement Report, dated January 9, 2002 (Exhibit C hereto). In that brief, the SEC wrote that "Rules 403, 407, 803 and 807 favor admission of the evidence at issue," id. at 3, and that the Commission "has a strong interest in the outcome of defendants' motions in limine because a holding that the Restatement and Restatement Report are inadmissible would create a precedent which may harm the Commission's efforts in other enforcement litigation focusing on material misstatements in registrant's financial statements." Id. at 1-2. The class plaintiffs in *Sunbeam Sec. Litig.* settled their claims against Andersen and the two individuals after the in limine motions were briefed, but before there was a decision on the motions.

[3] The ruling of Judge Jones in the criminal case against Bernard Ebbers, referred to in Andersen's letter of January 20, 2005, to the Court, is entirely inapposite because, among other reasons, the Government stipulated that it was not offering the restatement in its case in chief, and there is "a very good chance we won't seek to offer it" even on rebuttal. *See United States v. Ebbers,* No. 02 CR 1144 (BSJ) (S.D.N.Y. Jan. 18, 2005), Tr. at 4, 9. Thus, the issues discussed here were not joined in that criminal case.

scheduling conference, rather than as an informed argument on the admissibility of the Restatement. The second tack consists of arguments that go towards the weight of the evidence rather than its admissibility. Neither tack is appropriate in terms of the present motion to exclude relevant evidence from this case. For this reason, we deal up front with the legal arguments to the extent they are raised by Andersen, and we will thereafter address the extraneous materials cited by Andersen.

A. Andersen Has No Legal Basis To Exclude The Restatement

1. The Restatement Is Relevant Pursuant to Rules 401 and 402

Andersen argues that the Restatement is irrelevant in this case, but cites no authority for this proposition. Rule 402 provides, in relevant part, that "all relevant evidence is admissible, except as otherwise provided by the Constitution of the United States of the United States, by Act of Congress, by these rules, or by other rules prescribed by the Supreme Court pursuant to statutory authority." Fed.R.Evid. 402. Rule 402 works in tandem with Rule 401, and defines relevant evidence as "evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." Fed.R.Evid. 401. As stated by Judge Middlebrooks in *Uzzi*, Rule 401 sets forth an "expansive definition of relevance." *Uzzi*, 2003 U.S. Dist. LEXIS 15608 at *4-*5; see also *Gentile v. County of Suffolk*, 129 F.R.D. 435, 444, 447 (E.D.N.Y. 1990) (stating that "[t]ogether Rules 401 and 402 express the federal policy underlying the federal rules, which favors liberal admission of evidence" and "[t]he language of Rule 401 is deliberately inclusive; the intent of the rule's drafters was to admit 'evidence having *any* tendency' to support plaintiff's claim."), *aff'd*, 926 F.2d 142 (2d Cir. 1991).

Plaintiffs have asserted claims against Andersen under Section 11 of the Securities Act, 15 U.S.C. § 77k, Section 10(b), 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17

C.F.R. § 240.10b-5. As the Court is aware, it is incumbent on plaintiffs to demonstrate that WorldCom issued materially false and misleading financial statements during the Class Period. While the Court has already found that the first quarter 2001 WorldCom financial statements were materially false and misleading as a matter of law, Plaintiffs still must prove that the WorldCom financial statements for year-end 1999, 2000 and 2001 were materially false and misleading in order to successfully assert claims relating to Andersen's audit opinion letters for those financial statements. The purpose of the introduction of the Restatement is to assist in that regard.

Corrected financial statements are highly probative as to whether there are misstatements in a company's public filings and whether those misstatements are material. In fact, a company admits its prior disclosures were materially misstated when it issues restatements like the one issued in this case. *See In re Texlon Corps. Secs. Litig.*, 133 F.Supp.2d 1010, 1026 (N.D.Ohio 2000) (company could not dispute that earlier financial statements contained material misstatements where it issued a restatement); *In re Peritus Software Servs., Inc.*, 52 F.Supp.2d 211, 223 (D.Mass. 1999) ("…after-the-fact accounting admissions may suffice to show that material misstatements occurred in the financial statements…."); SEC *Amicus Curiae* Br. (Exhibit C) at 16-17. APB 20, the accounting rule governing restatements, further makes clear that a restatement may be made only if there were errors or irregularities in a prior financial statement, and that the error was known or should have been known based on information available at the time of the original statement. Thus, the fact of a restatement is itself significant as an admission of a company that there were facts in existence at the time upon which a GAAP-compliant accounting treatment should have occurred.

As was clearly presented in the SEC's *amicus curiae* brief filed in the *Sunbeam Sec. Litig.*, a public company is under an obligation to correct previous financial statements when it

finds that those statements contain material misstatements or omissions that may be relied upon by the investing public. Exhibit C at 6-11. This obligation arises from SEC Regulation S-X, which requires issuers to file statements that comply with GAAP and are audited in accordance with GAAS. *See* 17 C.F.R. 210.2-02 and 210.4-01. Further, courts in the Second Circuit have held that a company's duty to correct arises 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." *See In re IBM Corporate Sec. Litig.*, 163 F.3d 102, 109 (2d Cir. 1998) (quoting *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1331 (7th Cir. 1995)).

Because WorldCom was under a duty to correct material misstatements and omissions it had made in its previous filings with the SEC, the filing of the Restatement was neither voluntary nor could it be done capriciously. It was duly authenticated by WorldCom and KPMG witnesses with direct knowledge of the Restatement and the method by which it was compiled (Renna Tr. 41:24-25, Lindsay Tr. (Exhibit K) 13:5-10) and it was filed with the SEC only after an exhaustive investigation and analysis had been conducted by WorldCom, assisted by expert consultants and the Company's new auditor after Andersen was replaced in the spring of 2002. Renna Tr. at 30:10-22, 39:24-40:11; Malone Tr. 658:11-659:16. It was a public statement, made by a company that had – even by Andersen's admission – previously falsified its financial statements by billions of dollars, thereby requiring a restatement to be filed as required by SEC regulation. As such, the Restatement is highly probative of the material falsity of those earlier statements, and is one piece of evidence that would show that it is more probable than not that WorldCom's financial statements filed during the Class Period were materially false, which is a necessary element of Plaintiffs' claims.

2. The Restatement Is A Business Record Pursuant To Rule 803(6)

Rule 803(6) is the business records exception to the hearsay rule, and provides that a document not excluded by the hearsay rule may include

> [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 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…unless the source of the information or the method or circumstances of preparation indicate lack of trustworthiness.

Fed.R.Evid. 803(6). The Second Circuit has held that Rule 803(6) favors the admission of evidence if it has any probative value at all. *See, e.g., United States v. Williams*, 205 F.3d 23, 34 (2d Cir. 2000) (quoting *In re Ollag Constr. Equip. Corp.*, 665 F.2d 43, 46 (2d Cir. 1981)). The key determinative as to whether evidence may come in under Rule 803(6) is trustworthiness. *See, e.g., Saks International v. M/V Export Champion*, 817 F.2d 1011, 1013 (2d Cir. 1980). The fact that civil and criminal sanctions could result from WorldCom making false statements in their SEC filings establishes the trustworthiness of such filings. *See Ollag Constr.*, 665 F.2d at 46-47 (criminal sanctions for falsifying information in financial statements given to bank may establish the trustworthiness of such information).

a. The Restatement Was Filed In WorldCom's Ordinary Course Of Business

The Restatement is a business record of WorldCom. It was WorldCom's usual course of business to make filings with the SEC, including annual statements on Form 10-K such as the one that contains the Restatement. Andersen concedes that a traditional financial statement is "generally admissible as a business record of the audited entity" under Rule 803(6) even though based in part on hearsay. *Paddack v. Dave Christensen Inc.*, 745 F.2d 1254, 1257 (9th Cir. 1984). Andersen further acknowledges that investors rely on public filings because "the

potential for civil liability in the event of falsity of such financial statements provides an assurance of reliability." *See* Andersen Br. at 34.

Here, WorldCom was clearly under an obligation, pursuant to SEC Reg S-X and Section 10(b) of the Exchange Act, to correct material misstatements in its prior financial statements when those statements were being relied on or were likely to be relied on by the investing public. *See In re IBM,* 163 F.3d at 109. Indeed, in WorldCom's press release of June 25, 2002 (Exhibit D), and in its press release of August 8, 2002 (Exhibit E), WorldCom informed the investing public that it would be filing a formal Restatement of its prior financial statements, and Andersen acknowledged that it was withdrawing its audit opinion letter for the 2001 financial statements. *See* Exhibit D.[4] As Judge Middlebrooks stated in *SEC v. Uzzi*, "the Restatement and Report are admissible against Uzzi under Federal Rule of Evidence 803(6) as business records and are not excludable hearsay." Exhibit B at *5. Indeed, Andersen fails to distinguish how the Form 10-K issued by WorldCom containing the Restatement fails to provide the "assurance of reliability" that other such public filings have, being that all such filings contain the same "potential for civil liability" if they prove to be materially false, and there is direct evidence that the proponents of the Restatement, and its auditor, understood their obligation to file accurate financial statements, both for the year 2002, and the preceding years. Malone Tr. 498:15-499:20; 500:8-25; 501:10-21.

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[4] Andersen argues that Plaintiffs will not be prejudiced if the Restatement is not admitted as evidence at trial. We address this argument in more detail below. However, one of the impacts of the granting of Andersen's motion would be to leave the jury with the mistaken impression that the full extent of WorldCom's corrections of its financial statements were contained in the press releases of June 25 and August 8, 2002, which admitted only to overstatements of $3.8 billion and $3.3 billion, respectively, and did not contain any of the massive goodwill and other purchase accounting adjustments that brought WorldCom's total overstatement to $74 billion. Thus, granting Andersen's motion would keep the full extent of WorldCom's admissions of overstatements from the jury, and even mislead the jury into believing that the Company had admitted an overstatement of less than 10% of the actual overstatement recorded in the Restatement, thereby severely prejudicing Plaintiffs and misleading the jury on this crucial fact.

b. The Restatement Is A Sufficiently Contemporaneous <u>Business Record</u>

Andersen further argues that the Restatement lacks contemporaneousness, as it was filed "almost two years" after the discovery of the misstatements. However, the Restatement was issued shortly after the conclusion of one of the most extensive investigations ever performed in order that the Form 10-K filed by WorldCom properly and accurately restated the financial statements for the years 2000 and 2001. Under the governing law, the time frame measured is that between the investigation and the issuance of the report, <u>not</u> the time frame between the events investigated and the issuance of the report. As the court stated in *In re National Trust Group, Inc.*, 98 B.R. 90 (Bankr. M.D. Fla. 1989), when admitting into evidence a report of an internal auditor as a business record, "…this document deals with past events, however the contemporaneous requirement relates to the event of the audit and the subsequent report, not the records and information relied on by the auditor." *Id.* at 92. It is hard to imagine a scenario where a Restatement could be issued by a company, especially one of WorldCom's size, only weeks after it discovers that it has made material misstatements in previous filings to the SEC. Such a standard would only serve to either hasten investigations that should properly be deliberate, or to keep from juries the results of properly investigated restatements. Because the Restatement was issued as soon as was practical after the investigation into WorldCom's previous public filings had concluded (Malone Tr. 478:15-18), the Restatement satisfies Rule 803(6)'s contemporaneous requirement.

c. <u>The Restatement Contains Guarantees of Trustworthiness</u>

Finally, the Restatement is admissible as a business record because it constitutes WorldCom's good faith restatement of its previously issued fraudulent financial statements. By filing its Restatement, WorldCom confirmed, for the world and all of its investors, that it had materially misstated its previously issued financial condition, and quantified the amount of the

prior misstatements. This announcement came at a significant potential cost to the Company, including the cost of a potential SEC action if the Restatement were found to be improper. Any Restatement filed by WorldCom – which was a foregone conclusion once the admission of the first $3.8 billion overstatements during 2001 and the first quarter 2002 had been announced – was required to be accurate, or the company could be subjected to further penalties by the SEC. Thus, WorldCom had nothing to gain by filing an improper Restatement, and these circumstances only serve to confirm its trustworthiness.[5]

For all of these reasons, the Court should admit the Restatement into evidence as a business record pursuant to Rule 803(6).

3. The Restatement Is Admissible Pursuant to Rule 807

The Restatement is further admissible pursuant to Rule 807, the residual exception to the hearsay rule. Rule 807 provides, in relevant part,

> A statement not specifically covered by Rule 803 or 804 but having equivalent circumstantial guarantees of trustworthiness, is not excluded by the hearsay rule, if the court determines that (A) the statement is offered as evidence of a material fact; (B) the statement is more probative on the point for which it is offered than any other evidence which the proponent can procure through reasonable efforts; and (C) the general purposes of these rules and the interests of justice will best be served by admission of the statement into evidence.

Fed.R.Evid. 807. Should the Court determine that none of the other Rules of Evidence permits admission of the Restatement into evidence, which Lead Plaintiff submits already permits and requires its admission, the residual exception to the hearsay rule allows for the admission of the Restatement given its high probative value and equally high indicia of trustworthiness.

[5] Andersen seeks to impugn the trustworthiness of the Restatement by picking at certain of the adjustments made by WorldCom (*see* Andersen Br. at 21-23 and Exhibit 1-7 thereto); by citing the “fresh start” that WorldCom allegedly seized upon as it emerged from bankruptcy proceedings; and the alleged “motive” of WorldCom and KPMG to maximize the amount of the Restatement adjustments in order to show little or no taxable income during the years 2000 and 2001. We deal with these arguments below.

To be admissible under Rule 807, evidence must be (1) trustworthy, (2) material, (3) more probative than other available evidence, and must fulfill (4) the interests of justice and (5) notice. *See Parsons v. Honeywell, Inc.*, 929 F.2d 901, 907 (2d Cir. 1991) (interpreting prior residual exception under Rule 803(24)). These five indicia of reliability are to be examined to see whether the four classes of risk particular to hearsay evidence, which are insincerity, faulty perception, faulty memory and faulty narration, are minimized. *See Schering Corp. v. Pfizer Inc.*, 189 F.3d 218, 232 (2d Cir. 1999). Hearsay statements, however, "need not be free from all four categories of risk to be admitted under Rule 807." *Id.* at 233. An independent auditor report is a document that may be admitted under Rule 807. *See Freedman v. Value Health, Inc.,* 135 F. Supp. 2d 317, 332 n. 6 (D. Conn. 2001) (holding that Court would admit letter with attached independent auditor report drafted by KPMG under Rule 807).

The Restatement in this case was compiled by WorldCom, and audited by KPMG, one of the leading accounting firms in the world. Hundreds of thousands of hours were spent compiling information and assessing accounts and journal entries. As stated before, WorldCom had no ulterior motive in issuing the Restatement, and had nothing to gain by issuing a faulty Restatement. Therefore, all the circumstances point to the trustworthiness of the document.

The Restatement is also material, as it is being used to prove both that WorldCom's financial statements were false and that those statements were materially false. The Restatement is more probative as to these two points than any other piece of evidence that could be offered. Defendants have had ample notice that plaintiffs intend to introduce the Restatement into evidence at trial. Because the Restatement meets all of the requirements for admission under the residual exception to the hearsay rule, plaintiffs respectfully submit that the Restatement is admissible pursuant to Rule 807.

4. **The Restatement Is Admissible Pursuant To Rule 703**

The Restatement is also admissible under Rule 703 as the basis for an expert's testimony. Rule 703 provides

> The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, the facts or data need not be admissible in evidence in order for the opinion or inference to be admitted. Facts or data that are otherwise inadmissible shall not be disclosed to the jury by the proponent of the opinion or inference unless the court determines that their probative value in assisting the jury to evaluate the expert's opinion substantially outweighs their prejudicial effect.

Fed.R.Evid. 703.

All auditing and accounting experts in this case considered the Restatement in forming opinions concerning the falsity of the financial statements issued by WorldCom during the Class Period. While Defendants' experts take issue with certain of the methodologies and conclusions reached by WorldCom (and KPMG) in issuing and opining on the Restatement, none questions that WorldCom was required by SEC rules to file a Restatement. As a public document filed by WorldCom, and given the extensive investigation and explanations provided by WorldCom, KPMG and other percipient witnesses concerning the Restatement (Renna Tr. 72:25-73:12; Guy Tr. (Exhibit I) 156:2-159:3, 177:11-178:15; Clark Tr. (Exhibit G) 23:2-15), the Restatement and the testimony given with respect to the Restatement are evidence upon which Plaintiffs' expert, Harris Devor, was entitled to rely in reaching his conclusions. Thus, the Restatement, at the least, has limited admissibility under Rule 703 for the purpose of explaining Mr. Devor's testimony. *See, e.g., Katt v. City of New York*, 151 F.Supp.2d 313, 356 (S.D.N.Y. 2001).

5. **The Restatement Is Not Unfairly Prejudicial Pursuant To Rule 403**

Finally, Andersen posits that the Restatement should not be admitted pursuant to Rule 403 because it is unduly prejudicial, it would result in "numerous trials-within-a-trial," it would

confuse the jury, and it is cumulative. In making these arguments, Andersen makes no mention of the enormous probative value that the Restatement holds, instead relying on conjecture and other arguments that properly go towards the weight of the evidence rather than its admissibility.

Rule 403 provides

> Although relevant, evidence may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence.

Fed.R.Evid. 403. The Second Circuit has made it clear that Rule 403 is concerned with prejudice involving some adverse effect beyond tending to prove the fact or issue that justified its admission into evidence. See, *e.g.*, *United States v. Figueroa*, 618 F.2d 934, 943 (2d Cir. 1980); *In re Blech Sec. Litig.*, 2003 U.S. Dist. LEXIS 4650, *15 (S.D.N.Y. March 26, 2003) (noting that prejudice must be “substantial and unfair”). In this case, the Restatement is highly probative in showing elements of Plaintiffs’ claims, and Andersen is simply seeking to exclude evidence that is adverse to its positions, but this 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.'"), *cert. denied*, 435 U.S. 996 (1978).

The few cases cited by Andersen are inapposite given the circumstances of this case. None of the cases involves a document that has the indicia of trustworthiness that is accorded a public filing made by an issuer to the SEC, and none of the cases questions the admissibility of evidence that, like the Restatement here, has a high probative value as to specific elements of a party’s claims. Specifically, *United States v. Jacques Dessange, Inc.*, 2000 U.S. Dist. LEXIS 3596 (S.D.N.Y. March 21, 2000) (Cote, J.), involved a decision by an Immigration Judge that this Court stated contained “layers of hearsay in the form of summaries of the testimony given by

the six witnesses, and of those witnesses' descriptions of their conversations with others and of documents." *Id*. at *7. Further, this Court found that the decision was not probative and would not withstand a challenge to its admission based on relevancy alone. Evidence like that questioned in *Jacques Dessange*, which the Court found had no relevance, can clearly not be compared to the Restatement in this case, which possesses enormous probative value, in light of the fact that it admits – on behalf of the issuing company – the falsity of its prior financial statements, which is a key element of the Plaintiffs' Securities Act and Exchange Act claims.

Further, contrary to the defendant's argument that the Restatement is somehow cumulative, to exclude this highly probative evidence from trial would be unfairly prejudicial to plaintiffs. WorldCom issued the Restatement to correct past errors in its financial statements. The Restatement is highly probative as to whether the financial statements were materially false and misleading, and the amounts by which the financial statements were overstated. And the submission of the fact of the Restatement is not merely "cumulative" of the expert testimony that Plaintiffs' expert will offer at trial.

The significant probative value of the Restatement as to plaintiffs' claims mandates that defendants' motion to exclude the Restatement under Rule 403 be denied.

B. There Is No Basis to Exclude Evidence of the Restatement on the Basis of Andersen's Other Arguments

1. Counsel's Statement During a Scheduling Conference Does Not Estop Plaintiffs from Introducing the Restatement

Apparently recognizing that none of its arguments based on the Federal Rules of Evidence supports exclusion of the Restatement, Andersen seeks to use various statements made by Plaintiffs' counsel during a scheduling conference less than two weeks after issuance of the Restatement to argue, in essence, that Plaintiffs should be estopped from introducing the Restatement as evidence at trial. However, had Andersen really believed that the issue had been

decided at that point, why would they have sought such massive discovery concerning the Restatement -- requiring WorldCom, KPMG (the Company's auditor), American Appraisal Associates (a consultant to WorldCom), and DoveBid (a consultant to KPMG) to produce millions of pages of documents, and further requiring depositions of two Restatement-related witnesses from WorldCom (Renna and Passauer), three from KPMG (Malone, Guy and Lindsay), one from AAA (Mehm), and one from DoveBid (Matthew Clark). Indeed, although arguing that the Restatement should not be admitted as evidence in the case, tellingly Andersen has not sought to exclude testimony of Plaintiffs' expert, Harris Devor, to the extent he relies on the Restatement or the testimony that Andersen has moved to exclude from evidence. And Andersen has not made, and cannot make, any argument that it did not obtain sufficient discovery concerning the Restatement in advance of trial.

In fact, however, statements of counsel made during a scheduling argument do not, and should not, have any bearing on the admissibility of a document as evidence at trial. The colloquy cited by Andersen took place four months before the end of the discovery period, and more than five months before submission of expert reports. The crux of the argument was how much time, if any, the Court would grant for further discovery, and the extent to which discovery concerning the Restatement would be allowed. As the record amply demonstrates, the parties thereafter had four months for further discovery concerning the Restatement -- with Andersen noticing and taking depositions of the fact witnesses who authenticated the Restatement, and explained the materials and methodologies used to compile the adjustments required to make the Company's previously issued financial statements accurate. Thus, the colloquy concerning the limits of discovery and other scheduling matters is simply not germane to the admissibility of the Restatement, documents underlying the Restatement, or testimony concerning the Restatement.

2. <u>The Restatement Is Not Inadmissible as "Opinion" Testimony</u>

Andersen further attempts to convince the Court that the Restatement should be excluded on the grounds that it "is not a single record or report" and that it is only a set of "opinions of MCI new management and KPMG auditors." *See* Andersen Br. at 1. Andersen is wrong on both counts. First, the Restatement is contained within a single document -- the Form 10-K filed by WorldCom with the SEC on March 12, 2004 (Exhibit A). While WorldCom obviously developed multiple work papers, binders and other materials to support the adjusted financial statements for the Restatement, similar materials were admitted as part of the "Restatement and Report" by Judge Middlebrooks in *Uzzi* . *See Uzzi* at *5, n.1. Second, to say that the Restatement, and the adjustments to the financial statements filed fraudulently by WorldCom during the Class Period, and certified by Andersen, are mere "opinions" of WorldCom's management and its auditor is false. As noted earlier, a company is <u>required</u> (a) to issue financial statements in accord with GAAP, and (b) to issue corrected financial statements when previously issued financial statements are found to have been materially false when issued. 17 C.F.R. 210.2-02 and 210.4-01; *In re IBM*, 163 F.3d at 109. Those financial statements are not considered to be mere "opinions," and Plaintiffs are not attempting to introduce the Restatement as "opinion testimony" of experts. To the contrary, while other courts have admitted into evidence restatements and testimony relevant to restatements as admissible expert testimony, in this case Plaintiffs are seeking to introduce the Restatement as a fact relevant to the case, and as a fact upon which Plaintiffs' accounting expert is entitled to rely, to the extent he deems it appropriate, in forming his opinions, which are being introduced as expert opinion testimony.

Indeed, as WorldCom and KPMG witnesses testified, the personnel who worked on the Restatement were well aware that they were required to provide adjustments in accord with GAAP, not improperly utilizing hindsight, and otherwise using accounting standards from the

time of the original financial statements. Renna Tr. 118:18-123:16, 126:10-17; Malone Tr. 268:9-269:10; 562:23-563:11. They understood that APB 20 allows for a restatement only when the facts that existed at the time were known or should have been known, and that the restatement adjustments are required by GAAP. *See In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC), Opinion and Order (S.D.N.Y. Jan. 18, 2005), at 29**.** Moreover, had the Restatement been materially false or misleading, it would have been actionable as a false statement made by WorldCom. See 15 U.S.C. 78j(b) & 17 C.F.R. 240.10b-5; SEC *Amicus Curiae* Br. (Exhibit C) at 6, n.5**.** Thus, the Restatement is not "opinion." Even if it were considered to be "opinion," however, the remedy would not be to exclude the Restatement but, rather, to give an appropriate jury instruction on the manner in which the jury may consider it.[6]

Andersen's argument that alleged flaws in the Restatement render it inadmissible is similarly without merit. First, such alleged flaws would, at most, be matters for the jury to consider in weighing the evidence, and not determining factors in terms of whether the Restatement must be excluded. In *Am. Equities Group, Inc. v. Ahava Dairy Prods. Corp.*, 2004 U.S. Dist. LEXIS 6970, *29-30 (S.D.N.Y. April 23, 2004), the Court set forth this principle while citing extensive supporting case law on this issue. In *Ahava*, the Court quoted *United States v. Scholl*, 166 F.3d 964 (9thCir. 1999), *cert. denied*, 528 U.S. 873 (1999), in stating: "a party need not prove that business records are accurate before they are admitted. 'Generally, objections that an exhibit may contain inaccuracies, ambiguities, or omissions go to the weight

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[6] Andersen's further argument that the Restatement should be excluded because it might be seen by the jury as a "quasi-official determination that WorldCom's original financial statements were materially misstated and that Andersen's audits were not performed in accordance with professional standards" (*see* Andersen Br. at 25) is off base. First, any undue inferences that might occur from introduction of the Restatement -- like any other piece of evidence -- can be cured by a jury instruction. Second, the Restatement will be offered for the fact that it was issued by WorldCom, and the types of adjustments and their amounts that WorldCom stated in the Form 10-K. It will be for the jury to determine the weight to accord that evidence, among the other evidence presented by both sides, in light of the testimony presented by the fact witnesses with knowledge of the Restatement and expert opinions presented by Plaintiffs and Defendants. Thus, there would be no undue prejudice to Defendants from introduction of the Restatement.

and not the admissibility of the evidence.'" *Scholl*, 166 F.3d at 978 (quoting *United States v. Keplinger*, 776 F.2d 678, 694 (7thCir. 1985)); *see also United States v. Reyes*, 157 F.3d 949, 953 (2d Cir. 1998) (issues raised about business records go to weight and not admissibility). Second, there is not a shred of evidence to support Andersen's claim that WorldCom and KPMG were somehow "motivated" to maximize the amount of the restatement adjustments. To the contrary, the Restatement was undertaken based on evidence supporting the adjustments (Renna Tr. at 255:24-256:8), and it was in no way influenced by a motive to increase the amount of the adjustments. Malone Tr. at 681:16 - 683:3. As witnesses from both WorldCom and KPMG further testified, the Restatement was issued in accordance with GAAP (Passauer Tr. 155:17 - 156:5, 184:22 - 185:10; Malone Tr. 526:11 - 527:2). Indeed, the basis upon which Andersen seeks to impugn the motivations of WorldCom's management and KPMG's auditors are statements made in one of the Bankruptcy Examiner's Reports, *see* Andersen Br. at 11, which Andersen has moved to exclude from the trial, and which Plaintiffs agree should be excluded from the trial. *See* Andersen Motion to Exclude SIC Report, Interview Memoranda and Examiner's Reports, at 13; Lead Plaintiff's Response to Motion of Arthur Andersen LLP to Exclude SIC Report, Interview Memoranda and Examiner's Reports, at 1, n.1.

Andersen's argument – by its own words – amounts to sheer speculation. The most that Andersen says to impugn the Restatement on this basis is that the tax issues facing MCI and KPMG "may have impacted" the decision-making in the restatement process, and that these issues "may have provided" a motive for MCI new management and IPMG to rationale WorldCom's restated losses in 2000 rather than 2002. *See* Andersen Br. at 11. But Andersen has no evidence to support of its hypothetical claims of "conflict" and no evidence to support its ill-founded "motive" argument. To the contrary, as KPMG's Malone testified, there was no connection whatsoever between the alleged state tax issues raised by Andersen, and the outcome

of the Restatement, or KPMG's conclusion that the Restatement was prepared and filed in accordance with GAAP requirements. Malone Tr. 462:15-20, 526:11 - 527:2, 681:16-683:7; *see also* Heckler Tr. 26:9-18, 76:24-77:21, 82:19 – 85:14. This was because, in contrast to Andersen's speculation that WorldCom was motivated to issue as large a restatement as possible, and take advantage of "fresh start" accounting, KPMG was always concerned with its standing with the SEC and investment community -- a matter that Andersen need no longer worry about -- and knew that the Restatement was still required to comply with GAAP. Malone Tr. 498:15-503:25.[7]

Finally, in an effort to create the false impression that there are serious conflicts between the positions taken by Plaintiffs' accounting expert and the Restatement, Andersen attempts to persuade the Court to exclude the Restatement on the grounds that its specific findings are either inconsistent with GAAP or in conflict with the positions taken by Plaintiffs' expert, and therefore, according to Andersen, would be confusing to the jury. Andersen's arguments in this regard, as shown below, are makeweight and should be rejected.

Line Costs: Andersen questions the methodology that WorldCom used in making adjustment to the Company's reported line costs. Andersen Br. at 15. However, witnesses from both WorldCom and KPMG testified that the Company had not improperly utilized "hindsight" in making adjustments that would not be permitted by GAAP. Renna Tr. 118:18-120:3, 121:11-20, 126:10-17; Malone Tr. 268:9-269:10. Indeed, Andersen's critique of the Restatement in this regard ignores completely that WorldCom's own witnesses <u>confirmed</u> that Sullivan and Myers had directed line cost and other reserves to be drawn down in order to bulk up WorldCom's

[7] Andersen writes, at page 20 of its Brief, that testimony concerning the alleged lack of independence of KPMG and how the state tax issue raised in the Bankruptcy Examiner's Report "would inevitably -- and unnecessarily -- superimpose an entirely new level of complexity to an already complicated case." As noted above, not only does Andersen's argument rely on a Report that Andersen seeks to exclude from the trial, but it also have no evidentiary basis. Thus, it appears that Lead Plaintiff and Andersen agree on one thing: that Defendants should be precluded from introducing at trial any documents or testimony regarding the state tax minimization issue. *See* Lead Plaintiff's Motion in Limine to Exclude Reference to Alleged "Conflict".

reported earnings. See Myers Plea Allocution (Exhibit O), at 15-16; Vinson Plea Allocution (Exhibit P), at 29-30; Normand Plea Allocution (Exhibit Q), at 44; Yates Plea Allocution (Exhibit R), at 13-14. And Plaintiffs' expert, in fact, adopts the line cost and reserve reversal adjustment made in the Restatement for the period from the first quarter 2000 through the first quarter 2002. *See* Exhibit F, Amended Exhibit 5.

IPR&D: Andersen seeks to undermine the $3.1 billion adjustment made in the Restatement for improperly recorded IPR&D charges, by complaining that WorldCom applied an accounting standard that had not existed at the time of the earlier financial statements. Andersen Br. at 15-16. However, as Plaintiffs' expert testified, the $3.1 billion adjustment made in the Restatement -- and adopted by Plaintiffs' expert -- was taken in accordance with the accounting standards at the time of the initial financials, and the Restatement working paper's reference to a later accounting standard was merely confirmatory. Devor Rule 26 Report, para. 109-128 (Exhibit F); Devor Tr. at 406:8-407:7, 407:24-408:5 (Exhibit H).

Triggering Events: Andersen further questions the propriety of the $47 billion impairment charge to goodwill taken by WorldCom in the Restatement for the year 2000 by arguing that WorldCom's management "looked to facts, events, and conditions not known or apparent in 2000." Andersen Br. at 26. But the testimony of record hardly supports Andersen's charge. As Mr. Passauer of WorldCom testified, WorldCom personnel overseeing the Restatement concerning the impairment charge looked <u>only</u> to events and facts that were, or should have been, known to WorldCom personnel at the time, and did not use hindsight to support the impairment charge. Passauer Tr. 23:9-25:2, 100:4-17; *see also* Form 10-K (Exhibit A) at F-35 ("The Company believes that it has performed this analysis [referring to the impairment charge] without inappropriately relying on the use of hindsight."). KPMG's Malone similarly testified that the impairment charge was fully supported because (a) there had been a

triggering event by the end of 2000 based on the drastic decline in WorldCom's stock price, a November 1, 2000 WorldCom disclosure that its earnings going forward would be greatly diminished, and the facts of record that the assets obtained in the MCI acquisition (including, most importantly, WorldCom's long distance telephone lines) were not producing the revenues that WorldCom had projected at the time of the MCI acquisition. Malone Tr. 556:9-20, 557:6-559:12. Thus, as Plaintiffs' expert, Harris Devor, opined, the impairment charge taken in the Restatement for the year 2000 was entirely justified, based on the facts in existence and the governing accounting principles at the time. Devor Rule 26 Report, paras. 139-156; Devor Tr. at 328:6-18, 331:12-333:15.[8]

Unfavorable Line Cost Contracts: Andersen's attack on the reversal of reserve draw-downs taken by WorldCom as part of the Restatement fares no better. Indeed, in order to attack the Restatement on this ground, Andersen ignores completely the plea allocutions of WorldCom senior executives -- the very people who directed the fraudulent entries on WorldCom's books -- who admitted that they had directed improper reserve draw-downs in order to state financial results that met analyst expectations. See Myers Plea Allocution, at 15-16; Vinson Plea Allocution, at 29-30; Normand Plea Allocution, at 44; Yates Plea Allocution, at 13-14. While WorldCom may have sought to quantify the amount of the overstatements by looking at actual results of the contracts at issue, the actual fraud concerning these expense items has been admitted, and Andersen's attack on the Restatement is simply off base.[9]

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[8] Finally, Andersen's assertion that the impairment charge was inappropriate because no other large telecom companies had taken similar charges at the time (citing a draft internal KPMG document that was nowhere authenticated or identified) is beside the point, since in fact some companies did take such charges, and other large telecom companies had simply not grown through the types of acquisitions that WorldCom engineered, which led to the massive goodwill stated on the Company's financial statements.

[9] Andersen states, citing its opposition to Lead Plaintiff's motion for summary judgment, that in addition to the goodwill impairment charge: "The remaining $9 billion of 2000 restatement entries are also sharply contested." *See* Andersen Br. 18, n.2. To the extent those $9 billion of 2000 restatement adjustments were adopted by Plaintiffs' expert, this clearly presents an issue of fact for the jury to determine, but not a basis for exclusion of the Restatement.

*   *   *

When all is said and done, the relief Andersen seeks in its motion would severely prejudice Plaintiffs and keep from the jury highly relevant evidence -- the Restatement itself in addition to testimony and other supporting documentation of percipient witnesses -- on a matter of central importance to this case, the falsity of the financial statements issued by WorldCom, which financial statements Andersen certified as materially accurate and stated in accordance with GAAP. Andersen would thereby exclude from the trial not only the fact of WorldCom's massive overstatement (far larger than the press releases announcing that a restatement would be issued) but also a significant analysis that Plaintiffs' accounting expert was entitled to consider, and rely upon as appropriate. Indeed, by excluding the Restatement, Andersen would seek to portray Plaintiffs' accounting expert as having found that massive adjustments to the financial statements were appropriate, but keep from the jury that WorldCom itself admitted adjustments of the same magnitude.[10] Thus, while Andersen portrays the Restatement as unreliable -- largely on the basis of other methodologies that Plaintiffs' expert utilized to find that similar adjustment were required -- in fact, the report and testimony of Plaintiffs' accounting expert confirms in large part the validity of the Restatement, and the Restatement conversely confirms the propriety of the analysis and conclusions of Plaintiffs' accounting expert.

[10] Andersen cites to Devor's reply expert report that he "independently reviewed and analyzed" each of the accounting entries in the Restatement, but only considered in his analysis "a small percentage of the many, many entries that comprised the restatement." *See* Andersen Br. at 25-26. What Andersen fails to point out is that Mr. Devor adopted most, if not all, of the "big ticket" items in the Restatement, but did not seek to analyze the hundreds of other less significant adjustments made by WorldCom in its Restatement. While Plaintiffs certainly appreciate Andersen's positive citations to Mr. Devor's reports and analysis, the argument raised by Andersen is not a proper basis upon which to exclude the Restatement. The major adjustments that Mr. Devor opined were required to make WorldCom's financial statements GAAP compliant are also included within the Restatement issued by WorldCom -- which is clearly an unspoken motive for Andersen seeking to keep the Restatement from the jury.

CONCLUSION

For the foregoing reasons, Plaintiffs respectfully submit that Andersen's motion to exclude the Restatement and testimony concerning the Restatement should be denied.

Dated: January 21, 2005

Respectfully submitted,

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