

1 THOMAS P. O'BRIEN
United States Attorney
2 CHRISTINE C. EWELL
Assistant United States Attorney
3 Chief, Criminal Division
MICHAEL J. RAPHAEL
4 Assistant United States Attorney
Chief, Appeals Section
5 California Bar Number: 208232
MICHAEL R. WILNER
6 Assistant United States Attorney
Major Frauds Section
7 California Bar Number: 156592
1100 United States Courthouse
8 312 North Spring Street
Los Angeles, California 90012
9 Telephone: (213) 894-3391/0687
Facsimile: (213) 894-6269
10 E-mail: michael.raphael@usdoj.gov
michael.wilner@usdoj.gov
11 Attorneys for Plaintiff
United States of America

12
13 UNITED STATES DISTRICT COURT
14 FOR THE CENTRAL DISTRICT OF CALIFORNIA

15 UNITED STATES OF AMERICA,) No. CR 05-398-GAF
16)
Plaintiff,) GOVERNMENT'S OPPOSITION TO
17) DEFENDANT'S MOTION IN LIMINE TO
v.) PRECLUDE EVIDENCE OF
18) HOMESTORE'S REVENUE
STUART H. WOLFF,) RESTATEMENTS; MEMORANDUM OF
19) POINTS AND AUTHORITIES
Defendant.)
20) Hearing Date: December 15, 2008
21) Hearing Time: 1:30 p.m.
22)

23 Plaintiff United States of America hereby opposes defendant
24 Stuart H. Wolff's motion in limine to preclude all evidence of
25 Homestore's revenue restatements. The government will seek to
26 introduce limited evidence of the revenue restatements solely to
27 establish the materiality of the information that defendant is
28 charged with concealing from Homestore's auditors. There is no

1 better evidence that the concealed information was material than
2 the fact that the company restated its revenue in order to
3 eliminate the fraudulently inflated revenues. If defendant
4 agrees to stipulate to the materiality element, then the
5 government will not seek to introduce the revenue restatements.
6 Absent a stipulation, however, the government has the right to
7 introduce the restatements and brief testimony establishing their
8 significance in order to demonstrate materiality.

9 This opposition is based on the attached memoranda of points
10 and authorities of the parties, and any argument at the hearing
11 on this Motion.

12
13 Dated: November 7, 2008

Respectfully submitted,

14 THOMAS P. O'BRIEN
15 Acting United States Attorney

16 CHRISTINE C. EWELL
17 Assistant United States Attorney
18 Chief, Criminal Division

19 /s/

20 _____
21 MICHAEL J. RAPHAEL
22 MICHAEL R. WILNER
23 Assistant United States Attorneys

24 Attorneys for Plaintiff
25 United States of America
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1 MEMORANDUM OF POINTS AND AUTHORITIES

2 I. INTRODUCTION

3 During 2001, defendant Wolff and his co-conspirators
4 inflated Homestore's financial statements through the use of
5 fraudulent roundtrip deals. Those deals added approximately
6 \$67 million in phony sales to Homestore's quarterly results.
7 Following the full discovery of the scandal in early 2002 -- and
8 several months after defendant Wolff and the other culpable
9 parties left the company -- Homestore "restated" its results by
10 filing corrected reports with the SEC that eliminated the
11 bogus revenue from the company's financial statements.

12 Many of the criminal counts in the indictment require the
13 government to prove the materiality of defendant's misconduct.
14 For example, the government must prove that Homestore's quarterly
15 filings with the SEC were overstated in a material amount
16 (counts two through four), and that defendant Wolff lied to
17 Homestore's auditors about material matters (counts ten through
18 fourteen). In the original trial, defendant Wolff bitterly
19 disputed that the revenue from the roundtrip deals was material
20 to Homestore, even though that money represented a large
21 percentage of Homestore's advertising revenue and overall revenue
22 in 2001.

23 Proof that Homestore restated revenue from the roundtrip
24 deals is strong, if not conclusive, evidence of its materiality,
25 and it establishes the significance of the size of the revenue
26 inflation scheme. Testimony and evidence regarding the
27 restatement of this revenue is admissible for the limited purpose
28

1 (and with an appropriate limiting instruction from the Court) of
2 determining the materiality of the revenue overstatement.

3 Defendant incorrectly asserts that this evidence is a
4 "subsequent remedial measure" under Federal Rule of Evidence 407
5 intended to establish defendant's guilt here. That rule
6 expressly allows for the admission of evidence for purposes other
7 than proving culpability, and here the government will be
8 admitting the evidence to prove materiality. Moreover, the
9 restatement evidence is not a remedial measure taken by
10 defendant, but rather one taken by Homestore, which is not a
11 party to this case, so Rule 407's prohibition, meant to avoid
12 deterring remedial measures, does not apply here.

13 Defendant's hearsay objection fares no better. The
14 government intends to present testimony from Homestore's main
15 auditor and a member of the company's Board of Directors. Both
16 individuals are percipient witnesses with first-hand knowledge of
17 Homestore's finances. Both can testify competently about the
18 company's decision to eliminate the contested revenue from its
19 restated financial statements. That is not hearsay evidence.
20 The restated quarterly statements themselves are admissible under
21 the business record exception to the hearsay rule, or the catch-
22 all exception for documents as trustworthy as those admissible
23 under other exceptions.

24 Finally, evidence of Homestore's restatement of this revenue
25 is not unduly prejudicial to the defense. Defendant's counsel
26 has informed the government that defendant will be waiving his
27

1 right to jury trial. The government also will waive its right to
2 jury trial. Consequently, because this case appears to be headed
3 to a bench trial, the district court will be able to properly
4 apply the evidence only for its proper purpose, and not in an
5 unfairly prejudicial manner.

6 In any event, were there a jury trial, the government will
7 agree to a limiting instruction, and it will also minimize the
8 use of the evidence, tying it specifically to materiality in its
9 opening statement and closing argument. Defendant is entitled to
10 cross-examine the witnesses as to why the company restated
11 revenue, or to argue that this evidence should not be persuasive.
12 He further will be able to point to the limiting instruction in
13 closing argument, and explain clearly to the jury that the
14 restatements do not provide evidence of defendant's participation
15 and knowledge in the fraud in 2001. But, having put the
16 government to its proof on the question of whether the amount of
17 phony revenue here is material, defendant cannot properly deprive
18 the government of its best evidence of materiality.

19 **II. FACTS**

20 This is a corporate fraud case involving senior management
21 of Homestore.com. The Indictment charges defendant Stuart Wolff,
22 Homestore's former Chief Executive Officer, with participating in
23 a conspiracy with other members of Homestore's management to
24 inflate the company's reported financial results, and the
25 Indictment also alleges defendant violated several other
26 substantive securities laws.

1 The government intends to introduce trial evidence that will
2 demonstrate that Homestore filed inaccurate quarterly reports
3 with the SEC on Form 10-Q for the first three quarters of 2001.
4 This evidence will come through several Homestore executives, who
5 will testify that Homestore overstated its quarterly revenue by
6 tens of millions of dollars in those filings.

7 At trial, the government will carry the burden of showing
8 that the fraudulent revenue inflation scheme was material to
9 investors. For this reason, the government will seek to
10 introduce evidence that Homestore filed amended quarterly reports
11 with the SEC in early 2002.¹ Those quarterly reports restated
12 Homestore's financial performance to delete revenue that the
13 company previously reported from the bogus deals. The
14 restatement evidence will support the government's position that
15 the false information was material to investors. Indeed, when a
16 public company amends or restates quarterly reports in an SEC
17 filing, the restatement is publicly available, through the
18 Internet and through other means, just like other corporate
19 documents filed with the SEC.

20 In the prior trial, the government made only brief
21 references to the restatements during the testimony of three
22 witnesses, and the government again will limit the testimony in a
23 similar manner in the upcoming trial. Barbara Alexander, a
24 member of Homestore's board of directors, was directly involved

25
26 ¹ Defendant resigned from Homestore before then, and he
27 neither participated in the decision to restate revenue, nor did
28 he sign the amended financial statements.

1 in Homestore's decision to restate results, and her testimony
2 regarding Homestore's restatement covered only five trial
3 transcript pages. Richard Withey, the lead PWC accountant who
4 audited Homestore, also directly participated in the
5 restatements, and, at the prior trial, he responded to a few
6 questions regarding specific transactions for which Homestore
7 disavowed revenue it previously recognized. Withey also
8 summarized the total amount of revenue that Homestore
9 fraudulently recognized in 2001 (\$67 million) and later restated.
10 Finally, Mark Rowen, an analyst with Prudential Securities,
11 testified that Homestore's use of the phony 2001 revenue was
12 significant information that he would have considered important
13 in evaluating an investment in Homestore stock for his clients.²

14 The government will introduce the restated Homestore
15 Form 10-Qs into evidence as business records, and they will be
16 certified copies of publicly filed records.³ At no point during
17 the prior trial did the government ask any witness about the
18 contents of the exhibits, and the government does not intend to
19 do so at this trial. The restated reports were never displayed
20 to the jury. Finally, the government made only a brief reference

21
22 ² Former Chief Operating Officer John Giesecke and former
23 Chief Financial Officer Joseph Shew -- both of whom pled guilty
24 to conspiring with defendant to commit securities fraud --
25 testified about the general significance of a corporation
restating its results. However, neither executive testified
about Homestore's actual restatement, which occurred after
Giesecke and Shew had left the company.

26 ³ The government introduced the documents during the
27 testimony of an SEC representative; she did not testify about the
contents of the restated reports.

1 to Homestore's restatement in opening statement and closing
2 argument. In the current trial, the government intends to
3 proceed in a substantially similar manner.

4 **III. ARGUMENT**

5 BECAUSE DEFENDANT IS CONTESTING THE MATERIALITY TO
6 INVESTORS OF HOMESTORE'S OVERSTATED FINANCIAL STATEMENTS,
7 THE COMPANY'S RESTATEMENTS ARE RELEVANT AND ADMISSIBLE
8 EVIDENCE THAT THE GOVERNMENT MAY INTRODUCE TO DISCHARGE
9 ITS BURDEN

10 If defendant were to choose to stipulate that the
11 \$67 million in inflated revenue in Homestore's 2001 quarterly
12 reports was material to investors, then the government would
13 agree not to introduce evidence of Homestore's income
14 restatements. On the other hand, if, as in the prior trial,
15 defendant contests materiality, the government is entitled to
16 present evidence of Homestore's restatement of revenue to
17 discharge its burden of proving that Homestore's false statements
18 were material to investors.

19 Defendant is charged with violations of the federal
20 securities laws arising from the fraud scheme. The charged
21 offenses require the government to prove that defendant caused
22 Homestore to make materially false statements, which is a
23 question of fact that "must be assessed from the perspective of
24 the reasonable investor." United States v. Berger, 473 F.3d
25 1080, 1100 (9th Cir. 2007). The Ninth Circuit has held that it
26 is "self-evident" that the materiality of information regarding a
27 public company's "financial condition, solvency, and
28 profitability is not subject to serious challenge." Berger, 473

1 F.3d at 1103. If defendant accepts this proposition and
2 stipulates to materiality, the government will not introduce the
3 restatements, and defendant may avoid whatever prejudice (unfair
4 or otherwise) that he believes would flow from the introduction
5 of the evidence.

6 As in the prior trial, it appears that defendant again will
7 not stipulate to materiality and wishes to attempt to establish
8 that Homestore's inflated revenue was immaterial to investors.
9 For this reason, the government is entitled to present evidence
10 showing that Homestore's overstated financial statements were
11 material to investors. If the amount of fictional revenue was,
12 say, only a small fraction of Homestore's income, the company
13 might have decided that the revised information was not important
14 to investors. However, the bogus financial information here
15 represented a major portion of the company's advertising revenue,
16 causing Homestore's quarterly financial performance to exceed
17 analyst expectations. The fact that the company restated its
18 revenue is the best, and perhaps conclusive, evidence of
19 materiality. PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 695
20 (6th Cir. 2004) ("a restatement is an admission that financial
21 statements were materially false at the time they were made"); In
22 re Atlas Air Worldwide Holdings, Inc., 324 F. Supp. 2d 474, 486-
23 87 (S.D.N.Y. 2004) ("Pursuant to Generally Accepted Accounting
24 Principles ('GAAP'), previously issued financial statements
25 should be restated only to correct material accounting errors
26 that existed at the time the statements were originally

1 issued."); In re Peritus Software Servs. Inc. Securities Litig.,
2 52 F. Supp. 2d 211, 223 (D. Mass. 1999) ("after-the-fact
3 accounting admissions may suffice to show that material
4 misstatements occurred in the financial statements").

5 A. Admission of the Restatements Does Not Violate Federal
6 Rule of Evidence 407

7 Defendant claims that the restatements are inadmissible as a
8 subsequent remedial measure under Fed. R. Evid. 407. This is
9 incorrect, as that Rule provides affirmative authority to admit
10 the restatement evidence to prove materiality in this case.

11 Rule 407 provides that

12 evidence of the subsequent [remedial] measures is not
13 admissible to prove negligence, culpable conduct, a defect
14 in the product, a defect in a product's design, or a need
15 for a warning or instruction. This rule does not require
the exclusion of evidence of subsequent measures when
offered for another purpose, such as proving ownership,
control, or feasibility of precautionary measures, if
controverted, or impeachment.

16 Fed. R. Evid. 407 (emphasis added); see also Rule 407, comment to
17 1997 amendment ("Although this amendment adopts a uniform federal
18 rule, it should be noted that evidence of subsequent remedial
19 measures may be admissible pursuant to the second sentence of
20 Rule 407."); Wright & Graham, 23 Federal Practice & Procedure:
21 Federal Rules of Evidence § 5290 (2008) ("The list of permissible
22 uses in Rule 407 is illustrative, not exclusive; evidence of
23 subsequent repairs may be admitted for any purpose that does not
24 require an inference to the negligence or culpable conduct of the
25 repairer.")

1 In this trial, the government will not seek to admit
2 Homestore's restatements in order to prove defendant's knowledge
3 of, and participation in, the criminal scheme at Homestore, and
4 the restatements in fact do not constitute such proof. Wolff had
5 resigned from Homestore following the discovery of the fraud
6 scheme, and well before new management filed the corrected
7 reports. Rather, the government will seek to admit the
8 restatements, and limit any testimony and argument about them,
9 for the sole purpose of demonstrating materiality. This purpose
10 falls squarely within the authorization in Rule 407's second
11 sentence for the introduction of evidence of remedial measures
12 for purposes other than proving culpable conduct. See, e.g., In
13 re Air Crash Disaster, 86 F.3d 498, 531 (9th Cir. 1996) (evidence
14 of subsequent remedial design changes admissible to rebut
15 witness's claim that product was "state of the art"); Brown v.
16 Link Belt Corp., 565 F.2d 1107, 1109 n.2 (9th Cir. 1977)
17 (evidence of subsequent changes to a product proves feasibility
18 of changes without showing negligence or culpability). Thus, the
19 restatement evidence is admissible pursuant to the rule.

20 In any event, Rule 407 does not preclude admission of
21 evidence of the restatements, because the government is not
22 offering an admission of misconduct by a party to this case. Pau
23 v. Yosemite Park and Curry Co., 928 F.2d 880, 887-88 (9th Cir.
24 1991) (Rule 407 prohibits only evidence of remedial measures by a
25 defendant, as a non-defendant will not be deterred from taking
26 remedial measures due to the admission of such evidence); In re

1 Aircrash in Bali, Indonesia, 871 F.2d 812, 816-17 (9th Cir. 1999)
2 (same); Malone v. Microdyne Corp., 26 F.3d 471, 480 (4th Cir.
3 1994) (limiting the use of correction to financial statements
4 offered against corporation-defendant); In re CIT Group, Inc.,
5 Securities Litigation, 349 F. Supp. 2d 685 (S.D.N.Y. 2004) (same
6 restriction). The purpose of Rule 407 is to avoid deterring
7 subsequent remedial measures, Gauthier v. AMF Inc., 788 F.2d 634,
8 637 (9th Cir. 1986), but here there is no such concern, since
9 Homestore, not defendant, remedied the false financial
10 statements. The restatements are to be admitted against
11 defendant, not Homestore, the party that corrected its fraudulent
12 financial statements.

13 B. The Testimony About Homestore's Decision to Restate
14 Income Is Admissible Because It Will Come From
15 Percipient Witnesses, and the Restatements Themselves
Are Admissible As Business Records or As Trustworthy
Documents

16 Relevant evidence of (i) Homestore's decision to restate
17 results and (ii) the amended Form 10-Q quarterly filings with the
18 SEC is admissible. Two percipient witnesses with knowledge about
19 Homestore's finances (PWC auditor Withey and Homestore
20 boardmember Alexander) will testify from personal knowledge that
21 Homestore restated its financial results in early 2002. Both are
22 competent to explain what they did and knew when Homestore filed
23 the corrected quarterly reports.

24 The restated reports themselves are reliable business
25 records that fall under the exception to the hearsay rule in Fed.
26 R. Evid. 803(6). See In re Worldcom, Inc., Securities Litig.,

1 388 F. Supp. 2d 319, 327 (S.D.N.Y. 2005) (corporation's
2 restatement of income ruled an admissible business record)
3 (analysis provided in In re Worldcom, Inc., Securities Litig.,
4 2005 WL 375313 *6-*10 (S.D.N.Y. Feb. 17, 2005)). A business
5 record is admissible if: (1) made by a person at a regularly
6 conducted business activity with knowledge at or near the time of
7 the information recorded; and (2) kept in the regular course of
8 the business activity. See United States v. Ray, 930 F.3d 1368,
9 1370 (9th Cir. 1990). Such business records are "afforded a
10 presumption of reliability and trustworthiness that the
11 defendants failed to rebut." Freitag v. Ayers, 468 F.3d 528, 541
12 n.5 (9th Cir. 2006). "[F]inancial reports and audits are
13 admissible under Rule 803(6)" even if prepared in advance of
14 litigation so long as they are reliable and trustworthy. Condu
15 v. Howard Savings Bank, 986 F. Supp. 914, 918 (D.N.J. 1997). The
16 test of admissibility is "not the motivation of the employee
17 preparing the record, but the function served by the records in
18 the operation itself." United States v. Baxter, 492 F.2d 150,
19 165 (9th Cir. 1975). The key criteria are whether the report
20 "had business significance" apart from the litigation, and is the
21 type of report "upon which independent business decisions are
22 routinely made." Condu, 986 F. Supp. at 919; see also United
23 States v. Frazier, 53 F.3d 1105, 1110 (10th Cir. 1995)
24 (Department of Labor report following fraud disclosure admissible
25 as it "had business significance" apart from use in prosecution).

1 Even if the restatements did not qualify under the business
2 record exception, they are admissible under the "catch-all"
3 exception to the hearsay rule, Fed. R. Evid. 807. Such evidence
4 is admissible if it possesses "circumstantial guarantees of
5 trustworthiness equivalent to the listed exceptions to the
6 hearsay rule." United States v. Sanchez-Lima, 161 F.3d 545, 547
7 (9th Cir. 1998). The evidence must also: (1) relate to a
8 material fact; (2) be more probative on the point than any other
9 evidence that can be procured through reasonable efforts; and
10 (3) serve the general purposes of the rules of evidence and the
11 interests of justice. Id.

12 The Homestore restated financial statements qualify for
13 admission under either evidentiary rule. As a public company,
14 Homestore was under a statutory obligation to file accurate
15 quarterly reports. During trial, Homestore's former executives
16 and outside auditor will explain the significance of the
17 company's quarterly filings and the process for submitting them.
18 While the filing of these amended reports was an event out of the
19 ordinary, the documents themselves were identical in form and
20 content to other quarterly reports that Homestore regularly
21 prepared. Defendant cannot credibly claim that there was
22 anything untrustworthy about the restated financial statements.
23 Under the circumstances, the restatements contained reliable and
24 probative proof of the materiality of the overstated revenue from
25 the fraudulent roundtrip deals.

1 C. The Restatement Evidence Is Not Substantially More
2 Prejudicial Than Probative

3 As defendant has recently informed the government that he
4 will be waiving jury trial, and as the government also will
5 consent to a bench trial, there will be no concern that a jury
6 will be unfairly prejudiced by the restatements or the testimony
7 about them in violation of Federal Rule of Evidence 403. The
8 Court, of course, will be able to separate the evidentiary
9 purpose of the evidence (to demonstrate the materiality of the
10 suppressed information about the fraudulent deals) from the issue
11 on which defendant believes he could be unfairly prejudiced
12 (Homestore's admission that it overstated revenue due to fraud).

13 Regardless of who is the trier-of-fact, the government will
14 be using the restatements solely to establish that the revenue
15 reported in Homestore's 2001 quarterly reports was materially
16 overstated. Defendant would be able to avoid any prejudice
17 (unfair or otherwise) from the restatements by simply stipulating
18 to the materiality of the \$67 million in phony sales that
19 Homestore booked in 2001. With such a stipulation, the
20 government would agree not to elicit any restatement evidence.

21 Even if this case were to proceed before a jury, the
22 government will agree to a limiting instruction that would ensure
23 that the jury will not consider the restatement evidence for any
24 purpose other than proving materiality. Furthermore, as in the
25 prior trial, the government will minimize the possibility of any
26 unfair prejudice by keeping the restatement evidence to a minor
27 role at trial, and will ask witnesses only a handful of questions

1 about the restatements and make only brief mentions of them in
2 opening statements and closing arguments, tying each reference to
3 proof of materiality. Defendant, in turn, is welcome to point
4 the jury to the limiting instruction in his closing argument, and
5 explain that the timing of the 2002 restatements shows that they
6 do not bear on defendant's culpability in 2001. With these
7 precautions, the probative nature of the restatement evidence
8 clearly is not "substantially outweighed" by the danger of unfair
9 prejudice, Fed. R. Evid. 403.

10 **IV. CONCLUSION**

11 For the reasons set forth above, the government respectfully
12 requests that the Court deny defendant's motion in limine to
13 preclude evidence of revenue restatements.

14 Dated: November 7, 2008

Respectfully submitted,

15 THOMAS P. O'BRIEN
16 Acting United States Attorney

17 CHRISTINE C. EWELL
18 Assistant United States Attorney
Chief, Criminal Division

19 /s/

20 _____
21 MICHAEL J. RAPHAEL
MICHAEL R. WILNER
Assistant United States Attorneys

22 Attorneys for Plaintiff
23 United States of America
24
25
26
27