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CASE MANAGEMENT CONFERENCE SET

MAR 07 2009 9:00 AM

DEPARTMENT 212

SUMMONS ISSUED

15 **SUPERIOR COURT OF THE STATE OF CALIFORNIA**
IN AND FOR THE COUNTY OF SAN FRANCISCO

16 **LOU SOLTON, MONTEREY COUNTY**
17 **TREASURER, ON BEHALF OF THE**
18 **MONTEREY COUNTY INVESTMENT**
POOL,

Plaintiff,

19 vs.

20 **KERRY KILLINGER,**
21 **THOMAS CASEY,**
22 **STEPHEN ROTELLA,**
23 **RONALD CATHCART,**
24 **DAVID SCHNEIDER,**
25 **STEPHEN FRANK,**
26 **THOMAS LEPPERT,**
PHILLIP MATTHEWS,
MICHAEL MURPHY,
WILLIAM REED, JR.,
ORIN SMITH,
DELOITTE & TOUCHE, LLP,
and DOES 1 through 20,

Defendants.

CIVIL ACTION NO.:
CGC-09-485878

COMPLAINT FOR:

- 1. Fraud and Deceit
- 2. Negligent Misrepresentation
- 3. Breach of Fiduciary Duty and
- 4. Violations of Calif. Corp. Code § 25400
et seq.

JURY TRIAL DEMANDED

Complaint

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1 Plaintiff **Lou Solton, Monterey County Treasurer, on behalf of the Monterey County**
2 **Investment Pool** (“Plaintiff” or “County”) alleges the following based on the investigation
3 conducted by the County and its counsel, a review and analysis of **Washington Mutual, Inc.’s**
4 (“WaMu” or the “Company”) filings with the United States Securities and Exchange
5 Commission (the “SEC”), news articles and other media reports, press releases, interviews, and
6 other matters of record.

7 **I. INTRODUCTION**

8 1. Until its recent demise, Washington Mutual or “WaMu” was one of the largest
9 savings and loans in the United States. In addition to typical banking activities, WaMu’s home
10 loan business was a large source of its reported business success. In 2006 and 2007, about 70%
11 of WaMu’s net interest income was generated by residential real estate loans and
12 related products, much of it in California.

13 2. To help ensure the legitimacy and longevity of that business, WaMu and its senior
14 officers – the Individual Defendants herein – assisted by its long-time auditor, Deloitte & Touche
15 LLP, touted a number of risk management processes they were implementing and managing
16 within the Company, including an active Risk Management Group, use of reliable home
17 appraisals, extending home loans based on conservative loan-to-value (“LTV”) ratios, and some
18 of the highest underwriting standards in the industry to minimize the credit risk involved in
19 lending sums to borrowers. WaMu also reassured investors that it was taking appropriate
20 allowances for loan losses, based on highly developed statistical forecasting models to help it
21 appropriately calculate the reported “Allowance” every quarter.

22 3. However, contrary to WaMu’s disclosures and at the same time it was raising
23 funds from unsuspecting investors – such as Monterey County – WaMu senior management had
24 secretly decided to dramatically increase the level of risk assumed by the Company without
25 informing investors and abandoned recognized underwriting standards used to evaluate both
26 “prime” home mortgages and “subprime” loans. As a result, WaMu’s allowances were under
27 reported by hundreds of millions of dollars.

1 4. In 2008, WaMu finally revealed the full extent of its losses, acknowledging
2 that its portfolio of supposedly high-quality home loans was tainted with substantially impaired
3 assets. On November 3, 2008, WaMu defaulted on a coupon payment to the County. The
4 security is still in default today. As a result, the County has suffered substantial losses.

5 **II. JURISDICTION AND VENUE**

6 5. Plaintiff Lou Solton, the Monterey County Treasurer, sues on behalf of the
7 Monterey County Investment Pool, a local government investment pool operating under the
8 California Government Code. The County's Pool is managed by the Monterey County Treasurer
9 on behalf of the County, school districts, special districts and other Pool participants. The
10 County made the decision to purchase the WaMu note in California, and at all times the Pool has
11 held the WaMu note in its custodial account in California.

12 6. Each Defendant has sufficient contacts with California, is a resident citizen of
13 California, has property in California, and/or has otherwise purposefully availed himself or
14 herself of benefits from California so as to render the exercise of jurisdiction over each by the
15 California courts consistent with traditional notions of fair play and substantial justice. Prior to
16 its bankruptcy, WaMu conducted substantial business in California. Indeed, California was
17 WaMu's largest source of business. WaMu maintained several offices in California, including
18 several offices in San Francisco. Deloitte also conducted substantial business in California, and
19 presently maintains several offices in California, including an office in San Francisco.

20 7. The amount in controversy exceeds the jurisdictional minimum of this Court.

21 8. This action is not preempted by the federal Securities Litigation Uniform
22 Standards Act of 1998 ("SLUSA"), as this action is not a class action and is brought by a single
23 Plaintiff seeking damages. The claims are brought under California law, including California
24 Corporations Code § 25400 *et seq.*, which prohibits knowing or intentionally false or misleading
25 statements in connection with the sale of a security, and California common law.

1 9. Venue is proper in the City and County of San Francisco as many of the acts
2 and transactions that constitute violations of law complained of herein, including WaMu's
3 dissemination of untrue statements of material facts about the WaMu securities to the public
4 investors. The subject security is maintained in the County's custodial account in San Francisco.

5 **III. THE PARTIES**

6 **A. Plaintiff**

7 10. Plaintiff is **Lou Solton, Monterey County Treasurer, on behalf of the**
8 **Monterey County Investment Pool**, a local government investment pool operating under the
9 California Government Code. The County's Pool is managed by the Monterey County Treasurer
10 on behalf of the County, school districts, special districts and other Pool participants.

11 11. In reliance on Defendants' misrepresentations and omissions, as described below,
12 the County purchased and held the WaMu note in California and suffered substantial losses.

13 **B. Defendants**

14 **1. Officer Defendants**

15 12. Defendant **Kerry Killinger** ("Killinger") served as the Company's Chief
16 Executive Officer since 1990 and as a member of the Company's Board of Directors (the
17 "Board") since 1988. Killinger also served as the Company's President from 1988 through 2004,
18 and as Chairman of the Board from 1991 until June 30, 2008. Killinger served as a member of
19 the Company's Executive Committee since its creation in 1990, and as Chair of the Corporate
20 Development Committee since its creation in 1997. Killinger joined WaMu in 1982 and, until
21 his appointment as President in 1988, he held numerous positions, including executive vice
22 president; senior vice president for financial management, research, investor relations and
23 corporate marketing; and member of a three-person Office of the President. From 2005 through
24 2007, Killinger received over \$33 million in total compensation, including at least \$7 million in
25 bonus compensation.

26 13. Defendant **Thomas Casey** ("Casey") served as Executive Vice President
27 and Chief Financial Officer of WaMu since October 2002. Casey also served as a member of

1 the Executive Committee since 2002, overseeing the Company's corporate finance, strategic
2 planning and investor relations functions. From 2005 through 2007, Casey received over \$11
3 million in total compensation, including at least \$3 million in bonus compensation.

4 14. Defendant **Stephen Rotella** ("Rotella") served as WaMu's President and
5 Chief Operating Officer since January of 2005. Rotella was responsible for overseeing the
6 Company's retail banking, home loans, credit card, and commercial lines of business, as well as
7 the Company's technology group and day-to-day administration. Rotella also served on the
8 Executive Committee since joining the Company in 2005 and, from March 2005 to August 2005,
9 served as the Acting Head of the Home Loans Group. From 2005 through 2007, Rotella
10 received over \$29.7 million in total compensation, including at least \$6.9 million in bonus
11 compensation.

12 15. Defendant **Ronald Cathcart** ("Cathcart") served as Executive Vice President
13 and Chief Enterprise Risk Officer of WaMu from December 2005 until April 2008. Cathcart was
14 responsible for overseeing the credit, market, operational, and compliance risk functions for the
15 Company. Cathcart also served as a member of the Executive Committee from December 2005
16 to April 2008. During 2007, Cathcart received at least \$1.9 million in compensation.

17 16. Defendant **David Schneider** ("Schneider") served as Executive Vice
18 President and President of Home Loans since August 2005. Schneider was responsible for
19 overseeing all aspects of the Company's home lending operations, with responsibility for the
20 group's overall business strategy and its production and servicing channels. Schneider also
21 served as a member of the Executive Committee since August 2005. During 2005,
22 Schneider received \$2.3 million in total compensation, including at least \$492,000 in bonus
23 compensation.

24 17. Defendants Killinger, Casey, Cathcart, Rotella, and Schneider are referred to
25 as the "Officer Defendants."
26
27

1 **2. Director Defendants**

2 18. Defendant **Stephen Frank** (“Frank”) served as a director of the Company
3 since 1997, and since July 1, 2008, as Chairman of the Board. While a director, Frank served on
4 several committees, including the Audit Committee (1997-2008, Vice Chair 2001-2004, and
5 Chair 2004-2008); the Finance Committee (2001-2008); the Human Resources Committee
6 (2002-2008); and the Corporate Development Committee (2002-2008).

7 19. Defendant **Thomas Leppert** (“Leppert”) served as a director of the
8 Company since September 2005. While a director, Leppert served on several committees
9 including the Audit Committee (2005-2008); the Governance Committee (2005-2008, Chair
10 2008-2008); and the Corporate Relations Committee (2005-2008, Chair 2007-2008).

11 20. Defendant **Phillip Matthews** (“Matthews”) served as a director of the
12 Company since 1998. While a director, Matthews served on several committees, including the
13 Audit Committee (2001-2007); the Finance Committee (2001-2004); the Governance Committee
14 (1998-2008); the Human Resources Committee (2004-2008); and the Corporate Development
15 Committee (2006-2008).

16 21. Defendant **Michael Murphy** (“Murphy”) served as a director of the
17 Company since 1985. While a director, Murphy served on several committees, including, among
18 others, the Audit Committee (2004-2008); the Finance Committee (2001-2008, Chair 2001-
19 2004); and the Corporate Relations Committee (2000-2008).

20 22. Defendant **William Reed, Jr.** (“Reed”) served as a director of the Company
21 since 1970. While a director, Reed served on several committees, including the Audit
22 Committee (1996-2008); the Finance Committee (2004-2008); and the Governance Committee
23 (1996-2008, Chair from 1996-2008). Reed also served as a director for WaMu’s subsidiary,
24 Washington Mutual Bank.

25 23. Defendant **Orin C. Smith** (“Smith”) served as a director of the Company since
26 July 2005. While a director, Smith served on the Audit Committee (2005-2008), the Governance
27 Committee (2005-2008), and the Finance Committee (Chair 2008).

1 24. Defendants Frank, Leppert, Mathews, Murphy, Reed, and Smith are collectively
2 referred to herein as the “Director Defendants.” The Officer Defendants and the Director
3 Defendants are collectively referred to as the “Individual Defendants.” The Individual
4 Defendants, because of their senior positions at WaMu, were controlling persons of the Company
5 and possessed the power and authority to control the contents of WaMu’s reports to the SEC,
6 press releases, and presentations to securities analysts, money and portfolio managers,
7 institutional investors, and individual investors such as the County – *i.e.*, the market.

8 **C. Auditor Defendant**

9 25. Defendant **Deloitte & Touche, LLP** (“Deloitte”) is a public accounting firm with
10 offices throughout the world, including in San Francisco, California. Deloitte served as WaMu’s
11 outside auditor for years and at all times relevant hereto. WaMu engaged Deloitte to audit its
12 financial statements, as well as to provide a written report as to whether the internal controls
13 were effective and whether the financial statements were fairly presented. WaMu also engaged
14 Deloitte to perform reviews of its quarterly financial results. For its work, Deloitte earned tens of
15 millions of dollars in annual fees, including an estimated \$15 million in 2007 alone.

16 **D. Doe Defendants**

17 26. Except as described herein, Plaintiff is ignorant of the true names of Defendants
18 sued as Does 1 through 20 inclusive and, therefore, sues these Defendants by such fictitious
19 names. Plaintiff will seek leave of the Court to amend this Complaint to allege their true names
20 and capacities when they are ascertained.

21 27. Plaintiff alleges that each of these Doe Defendants is responsible in some manner
22 for the acts and occurrences alleged herein, and that Plaintiff’s damages were caused by such Doe
23 Defendants.

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E. Agents and Co-Actors

28. At all relevant times, each Defendant was and is the agent of each of the remaining Defendants, and in doing the acts alleged herein, was acting within the course and scope of such agency. Each Defendant ratified and/or authorized the wrongful acts of each of the Defendants.

29. Defendants, and each of them, are individually sued as participants and as aiders and abettors in the improper acts, plans, schemes, and transactions, to induce Plaintiff to purchase and hold the securities that are the subject of this Complaint.

30. Defendants, and each of them, have participated as members of the fraud or acted with or in furtherance of it, or aided or assisted in carrying out its purposes alleged in this Complaint, and have performed acts and made statements in furtherance of the violations and conspiracy.

F. Unnamed Participants

31. Numerous individuals and entities participated actively during the course of and in furtherance of the conspiracy and concealed such information from the public. There was a conspiracy and many acts were done in the course of and in furtherance of the conspiracy by statements, conduct, and intent to defraud. The individuals and entities acted in concert by joint ventures and by acting as agents for principals, in order to advance the objectives of the conspiracy. The acts were intended to promote the conspiratorial objectives.

IV. FACTUAL ALLEGATIONS

A. The County And Its Investments

1. State Law Authority and Requirements

32. Under California Government Code Section 27000, each California county is required to maintain a pooled treasury, comprised of funds belonging to the county, as well as to school districts, special districts, cities and other local agencies within the county. The pool is referred to as a local government investment pool or "LGIP."

1 33. The benefits of pooling money are identified in Government Section 27130,
2 which recognizes that “by pooling deposits from local agencies and other participants, county
3 treasuries operate in the public interest when they consolidated banking and investment activities,
4 reduce duplication, achieve economies of scale, and carry out coherent and consolidated
5 investment strategies.”

6 34. Pursuant to state law, the primary objectives in managing public funds, in order of
7 priority, are to 1) safeguard the principal of the funds; 2) satisfy the liquidity needs of depositors;
8 and 3) achieve a return on the funds. Cal. Govt. Code § 27000.5. Consistent with these
9 objectives, state law places strict limitations on the instruments in which local agencies may
10 invest, as well as the concentration of such investments. For example, treasury pool investments
11 are limited, by statute, to conservative instruments such as U.S. Treasury obligations, highly-
12 rated commercial paper, certificates of deposit, and the like. Investment pools are prohibited, by
13 statute, from investing in equities and are not allowed to purchase other instruments, such as
14 “inverse floaters,” “range notes,” “interest only strips,” and any other securities which could
15 result in zero interest accrual if held to maturity.

16 35. State law also places restrictions upon a pool’s concentration of investments.
17 Such restrictions depend on the instruments at issue, as well as the type of local entity making the
18 purchase. For example, Government Code Section 53636, which applies specifically to county
19 pooled funds, authorizes county pools to invest up to 10% of fund proceeds into the commercial
20 paper of a single issuer so long as the issuer has a rating of A-1/P-1/F-1. Section 53635 also
21 allows up to 30% of a pool’s funds to be invested in “medium term notes,” but only 20% of the
22 pool’s funds to be invested in mutual funds and money market mutual funds.

23 **2. The Structure And Investment Policy Of the Monterey County**
24 **Investment Pool**

25 36. The Monterey County Investment Pool has existed for many years. In addition to
26 the County, numerous local agencies participate in the Pool, including school districts, cities, and
27 many special districts. The funds are used to finance virtually all services provided by the
28 County, cities and local agencies and districts, including payroll and purchases.

1 37. The County Pool’s investments are governed by the County’s Investment Policy,
2 developed and adopted pursuant to Government Code Section 27133. The Investment Policy
3 sets forth the philosophy for investing the funds in the Pool, the objectives of the Pool, the
4 allowable investment instruments, the maturity and average life of Pool investments, and specific
5 qualifications of the investments. The Policy sets forth controls relating to investment authority,
6 reporting, auditing, accounting methods, withdrawal request and other related control matters.
7 Finally, the Policy sets forth the procedures to be followed in executing investment transactions.

8 38. In accordance with Section 27133, the Treasurer annually prepares the Policy
9 which is reviewed by the Treasury Oversight Committee and ultimately approved by the Board of
10 Supervisors. Pursuant to Government Code Sections 27130 and 17131, the Treasury Oversight
11 Committee 1) insures participation by local agencies in the review of investment policies, 2)
12 involves participating local agencies in the management of their funds, and 3) enhances the
13 security and investment return of their funds by establishing criteria for the withdrawal of funds.

14 39. Pursuant to the County’s Investment Policy, the responsibility for making
15 investments resides with the Treasurer who supervises the investment program within the
16 guidelines of the Policy and state law. The Treasury Oversight Committee meets to evaluate
17 general strategies and to monitor results and discuss the economic outlook, portfolio
18 diversification, maturity structure and potential risks to the Pool. The Treasury Oversight
19 Committee causes an annual audit to be conducted of the portfolios, procedures, reports and
20 operations related to the Pool.

21 40. The investment objectives of the County’s Investment Policy are consistent with
22 state law and can be summarized, in order of priority, as: (1) safety, (2) liquidity and (3) return on
23 investment.

24 41. As a result of these statutory mandates, the County has a long history of
25 maintaining high quality investment portfolios governed by a disciplined investment strategy of
26 diversification and conservatively designed to achieve a reasonable balance of risk and a stable
27 source of earnings. The County’s approved investments include U.S. Treasury and government
28

1 securities, commercial paper, corporate bonds, and repurchase agreements with highly rated
2 counterparties.

3 42. Unfortunately, in reliance on Defendants' misrepresentations and omissions,
4 described in more detail below, the County purchased a substantial interest in a WaMu note
5 which is now worthless. The note was purchased on July 11, 2007, with a maturity date on May
6 1, 2009. The par amount of the note was \$20,000,000.00 with a 5.44625% coupon. The note
7 was rated A1 by Moody's, A by Fitch, and A by Standard and Poors. The County made its
8 decision to purchase the WaMu note in California and, at all times, held the note in its custodial
9 account in California.

10 **B. Overview of WaMu's Lending Business**

11 43. Until its demise, Washington Mutual, Inc. ("WaMu") was one of the largest
12 savings and loans in the United States. Headquartered in Seattle, Washington, WaMu had a
13 particularly strong lending and fund raising presence in California. WaMu operated as a savings
14 and loan holding company with banking subsidiaries and nonbanking subsidiaries. Its banking
15 subsidiaries included, among others, Washington Mutual Bank, formerly known as Washington
16 Mutual Bank FA, and Washington Mutual Preferred Funding LLC.

17 44. WaMu had four operating segments: the Home Loans Group, the Retail Banking
18 Group, the Card Services Group and the Commercial Group. As set forth in the Company's
19 Form 10-K for the year-ended December 31, 2006 (the "2006 Form 10-K"), the primary activities
20 of the Home Loans Group include the origination and servicing of home loans, the fulfillment
21 and servicing of home equity loans and lines of credit, and the managing the Company's capital
22 market operations, which includes the buying and selling of all types of real estate secured loans
23 in the secondary market.

24 45. Within WaMu's Home Loans Group, WaMu's subprime mortgage channel
25 originated, purchased, and held for investment home loans and home equity loans issued to
26 subprime borrowers. WaMu originated subprime loans through its subprime division (known for
27 some time as "Long Beach Mortgage" ("LBM") and known thereafter as the Company's

1 “specialty mortgage lending” channel) and also purchased loans from subprime lenders. WaMu’s
2 subprime channel was originally part of the Company’s Commercial Group, but was moved to
3 the Home Loans Group in 2006. As of December 31, 2006, WaMu’s subprime mortgage channel
4 loans held for investment totaled \$20.77 billion, of which \$4.40 billion were originated by LBM
5 and \$16.37 billion were purchased from outside subprime lenders.

6 46. The primary activities of WaMu’s Retail Banking Group included: (1) offering a
7 comprehensive line of deposit and other retail banking products and services to consumer and
8 small businesses; (2) holding both the Company’s portfolio of home loans held for investment
9 and the substantial majority of its portfolio of home equity loans and lines of credit (but not the
10 Company’s portfolio of mortgage loans originated or purchased through the subprime mortgage
11 channel); (3) originating home equity loans and lines of credit; and (4) providing investment
12 advisory and brokerage services, sales of annuities and other financial services.

13 47. In addition to its operating segments noted above, WaMu maintained a
14 “Corporate Support/Treasury and Other” business segment which, among other things, managed
15 the Company’s: (1) interest rate risk, liquidity position, and capital; (2) enterprise-wide
16 identification, measurement, monitoring, control, and reporting of credit, market, and operational
17 risk; (3) community-lending and investment activities; (4) impact of changes in the unallocated
18 allowance for loan losses; (5) net impact of fund transfer pricing for loan and deposit balances;
19 and (6) transfers of loans from the Retail Banking Group to the Home Loans Group.

20 48. WaMu originated residential loans through its retail and wholesale lending
21 operations, which were primarily issued through WaMu’s Home Loans and Commercial Groups.
22 Under the Company’s underwriting standards, WaMu purportedly required documentation of the
23 borrower’s credit history and score, income, debt level, and other factors.

24 49. After originating home loans, WaMu either (a) retained the loans as investments
25 in its “held for investment” portfolio, which generally were reflected as assets in the Company’s
26 public financial reports and in other information disseminated to the public; or (b) held such
27

1 loans for sale, and, accordingly, securitized or sold off such loans to third parties in due course,
2 primarily through the Capital Markets Division of WaMu's Home Loans Group ("WaMu Capital
3 Corp.").

4 50. WaMu reported significant income from its home lending operations. With
5 regard to its loans "held for investment," however, WaMu was also required to maintain and
6 publicly report a reserve amount for probable losses related to such loans (for example, losses
7 from WaMu borrowers defaulting on their obligations to make mortgage payments). WaMu
8 referred to its loss reserve as its Allowance for Loan and Lease Losses (the "Allowance").
9 WaMu's Allowance was one of only five "earnings drivers" that the Company discussed each
10 quarter, and was a critical metric for investors because, as the Company's 2006 Form 10-K
11 explained, "[t]he [Allowance] represents management's estimate of incurred credit losses
12 inherent in the Company's loan and lease portfolios as of the balance sheet date." WaMu was
13 required to periodically reassess and adjust its Allowance, or "provision," for any such loan and
14 lease losses. Increases in the Allowance reduced WaMu's earnings because such charges are
15 recorded as an expense. Thus, WaMu's reported Allowance was directly linked to net income
16 and the Company's earnings per share.

17 51. WaMu repeatedly reassured investors about the quality of its loans to
18 third-party purchasers of its residential loans, since it knew the materiality of such information.
19 If purchasers determined that the Company had breached its representations and warranties, or if
20 a borrower defaulted early in the term of the loan, the purchasers could hold WaMu accountable
21 for losses by requiring WaMu to repurchase the loans. WaMu was also required to maintain an
22 appropriate reserve for such losses.

23 **C. 2005-2007: WaMu Embarks On Risky Loan Program To Drive New Profits**

24 52. In February 2005, WaMu publicly announced a five-year plan for the Company
25 which called for "[t]ransforming the company's mortgage business and maintaining a leading
26 national position in mortgage lending," while also "[m]aintaining risk management as a top
27 priority."

1 53. The new plan was implemented by WaMu's senior management, many of whom
2 held brand new positions at WaMu. For example, Defendant Rotella joined the Company as
3 President and Chief Operating Officer in January 2005, and became the acting president of the
4 Home Loans Group in March. In July 2005, Defendant Schneider was appointed as the President
5 of the Home Loans Group. By the end of 2005, the Company also installed a new Chief
6 Enterprise Risk Officer, Defendant Cathcart.

7 54. The Company began to promote riskier loan products to both prime borrowers
8 (borrowers who appeared to be creditworthy) and subprime borrowers, while reducing the share
9 of traditional, fixed rate loans it originated. The Company focused heavily on originating loan
10 products, such as WaMu's "flagship" product, the Option Adjustable Rate Mortgage loan
11 ("Option ARM"), and subprime loans that were "nonconforming," i.e., they did not meet the
12 specifications required by the government-sponsored entities ("GSEs"), such as Freddie Mac or
13 Fannie Mae. Because these nonconforming loans were riskier, WaMu could charge much higher
14 interest rates and fees for their origination.

15 55. While WaMu acknowledged publicly that it had altered its loan origination mix
16 in favor of generating more loans with higher profit margins, WaMu and the other Defendants
17 did not reveal the full extent of WaMu's highly questionable and unlawful practices directed by
18 the Individual Defendants to artificially fuel WaMu's growth targets.

19 56. Option ARMs made up the majority of WaMu's "prime" mortgage originations,
20 as well as the majority of the loans in WaMu's "held for investment" portfolio of loans. Option
21 ARM loans always made up more than fifty percent of WaMu's held for investment loan
22 portfolio and, in the fourth quarter 2006, Option ARM loans comprised \$63.6 billion – or 64% –
23 of WaMu's entire \$99.5 billion loan portfolio.

24 57. WaMu's Option ARM had a minimum payment option based on the interest rate
25 charged during the introductory period, and was almost always significantly lower than the loan's
26 fully-indexed payment rate. The fully-indexed rate was calculated using an index rate plus a
27 margin. When the introductory or "teaser" period ended, typically after a period of several

1 months, the contractual interest rate charged on the loan increased to the fully-indexed rate and
2 adjusted monthly to reflect movements in the index. Moreover, if a WaMu Option ARM
3 borrower continued to make only a minimum monthly payment after the introductory period
4 ends, his or her payments often were not sufficient to cover the interest accrued on his or her
5 loan, resulting in “negative amortization” of the Option ARM loan as unpaid interest is deferred
6 and added to the loan’s principal balance. WaMu “capped” the amount of negative amortization
7 on its Option ARM loans from 100% to 125% of the original loan balance. So if a WaMu
8 borrower reached the negative amortization cap (or at least every 60 months), the borrower’s
9 WaMu loan was subject to “recasting,” where a new minimum monthly payment is calculated
10 that is sufficient to fully repay the principal balance of the loan, including any deferred interest,
11 over the remainder of the loan term using the fully-indexed rate then in effect.

12 58. WaMu booked negative amortization amounts on its Option ARM loans as
13 deferred interest earnings on its income statement, thereby reporting non-cash income created
14 solely from a borrower’s failure to pay full interest. Thus, WaMu could keep its Option ARM
15 mortgages on the Company’s books and record the deferred interest from them as income. The
16 unpaid Option ARM principal balance, which was recorded by WaMu as non-cash income, rose
17 from \$76 million in the third quarter 2005 to \$1.7 billion in the fourth quarter 2007.

18 59. The Company falsely represented that it was managing the Company’s risk
19 associated with its Option ARM products by ensuring compliance with appropriate underwriting
20 standards, monitoring loan performance, and conducting risk modeling procedures. It was not.
21 For example, although the Company claimed that it did not offer Option ARM loans to subprime
22 borrowers, WaMu in fact issued Option ARM loans to borrowers with low credit scores
23 generally considered subprime. Moreover, WaMu underwrote many of its Option ARM loans at
24 the loan’s introductory interest rate, rather than, as represented, at the loan’s fully-indexed
25 interest rate. In other words, WaMu often qualified its Option ARM borrowers based on their
26 ability to pay temporary, very low “teaser” interest rates rather than the much higher interest rates
27 that would be in place for the overwhelming majority of the Option ARM loan term.

1 60. WaMu also offered stated-income loans, which are mortgages in which the lender
2 does not verify the borrower's income by examining their pay stubs, W-2s, bank statements, tax
3 documents or other records. Instead, WaMu simply asked the borrower for his or her income
4 without further confirmation. For this reason, stated-income loans are particularly risky. While
5 initially intended for self-employed borrowers with good credit, WaMu extended them to
6 subprime borrowers. Similarly, WaMu issued "no-doc" or "low-doc" loans, also referred to as
7 "Alt-A" loans, which were loan products offered to borrowers that require little to no
8 documentation from the borrower.

9 61. To drive business, the Officer Defendants established a system of financial
10 rewards for originating risky loans, and imposed penalties on those who did not. WaMu loan
11 production personnel were compensated based on loan volume without any regard to loan
12 quality, and were paid even more for originating riskier loans, including Option ARM loans.
13 Thus, WaMu's employees, targeted borrowers who were less able to afford the loan payments
14 they would have to make.

15 62. In November 2005, Defendant Cathcart was hired to lead WaMu's Enterprise
16 Risk Management. Killinger announced, "Ron has a proven track-record in developing and
17 leading risk management organizations He is a seasoned professional with a deep
18 understanding and familiarity with all facets of risk management." Cathcart replaced James
19 Vanasek, who had been the Company's Chief Enterprise Risk Officer since 2004.

20 63. However, soon thereafter, WaMu secretly discontinued appropriate risk
21 management practices. Even when WaMu's risk management teams identified critical problems
22 with WaMu's business and accounting practices and brought those matters to the attention of
23 WaMu's senior management, appropriate remedial actions were not taken.

24 64. For example, WaMu regularly compiled "Risk Reports" to verify that the
25 Company as a whole was within guidelines ultimately established by WaMu's Board of
26 Directors. These reports noted that Company was exceeding certain risk parameters, but were
27 ignored.

1 65. WaMu’s senior management also encouraged real estate appraisals to be
2 manipulated so that loans could go through. Appraisers were put under intense pressure to “hit”
3 higher appraisal values and, if they refused, were not included on “preferred” appraiser lists. As
4 a result, WaMu originated loans that had artificially low (*i.e.*, favorable) loan-to-value (“LTV”)
5 ratios and loans that otherwise never would have been approved at all.

6 66. The practice greatly increased the risk to WaMu, and thus, to its
7 noteholders, such as plaintiff. As explained in WaMu’s 2006 Form 10-K: “Credit risk is the risk
8 of loss arising from . . . the availability and quality of collateral.” By misrepresenting the value
9 of underlying loan collateral through manipulating appraisals, WaMu was exposed to a
10 substantial risk of loss from loans in WaMu’s “held for investment” portfolio and to a substantial
11 risk on loans originated by WaMu and “held for sale” (that is, sold to third parties or securitized),
12 due to a contingent risk of loss upon the exercise of recourse upon default or the discovered
13 violation of the representations and warranties, both of which would force WaMu to repurchase
14 such loans.

15 67. Nonetheless, the Officer Defendants touted the Company’s low LTV ratios
16 concerning the Company’s portfolios of loans to reassure investors that the Company was not
17 taking on an inordinate amount of credit risk. According to Defendant Rotella, the Company’s
18 reported LTV ratios gave the Company a “measure of protection against losses going forward,
19 because we do have a fair amount of cushion in those portfolios on average.”

20 68. WaMu also under-reserved for loan losses based upon misstated collateral values.
21 As stated in WaMu’s 2006 Form 10-K, “[t]he estimation of the allowance [for loan and lease
22 losses] is based on a variety of factors, including. . . the estimated value of underlying collateral.”

23 69. Fair and accurate appraisals are of paramount importance to home borrowers
24 because an appraisal that inflates the value of a borrower’s home as too high can
25 cause that borrower to take a loan in excess of the borrower’s actual needs and ability to pay and
26 that is also unjustified by the market value of the borrower’s home. The result of an inflated
27 appraisal, therefore, is significant additional risk for the borrower – and the lender.

1 70. Accordingly Federal regulations stress the importance of appraisals:

2 The soundness of a savings association’s mortgage loans and real estate
3 investments, and those of its service corporation(s), depends to a great extent upon
4 the adequacy of the loan underwriting used to support these transactions. **An**
5 **appraisal standard is one of several critical components of a sound**
6 **underwriting policy because appraisal reports contain estimates of the value of**
7 **collateral held or assets owned.**

8 12 C.F.R. § 564.8(a) (Emphasis in original.)

9 71. Independent appraisals were supposed to be used to determine reliable
10 LTV ratios for loans originated by WaMu. As WaMu explained in its 2005 Amended Form 10-
11 K, “[t]he loan-to-value ratio measures the ratio of the original loan amount to the appraised value
12 of the collateral at origination.” Thus, the LTV ratio is directly dependent on appraisal value, and
13 any error or fraud related to an appraisal will necessarily affect the LTV ratio. Artificially
14 increased appraisals lead to artificially **decreased** LTV ratios, which make a company’s loan
15 portfolio look less risky than it really is.

16 72. WaMu repeatedly acknowledged the key role of real estate appraisals to its home
17 lending business. For example, in its Amended 2005 Form 10-K, WaMu emphasized the critical
18 importance of appraisals and LTV in predicting loan performance (and therefore in measuring
19 and controlling for risk), stating:

20 The Company’s experience shows that debt-to-income ratios are less predictive of
21 loan performance than credit scores and loan-to-value ratios, which the Company
22 believes are the two key determinants in forecasting future loan performance.

23 The Company and the Officer Defendants made statements to the same effect in WaMu’s 2006
24 and 2007 Form 10-Ks and in quarterly financial statements.

25 73. Similarly, in its Amended 2005 Form 10-K, which included Deloitte’s unqualified
26 audit opinions on the Company’s financial statements and management’s assessment of internal
27 controls, WaMu stated:

1 Home loans with loan-to-value ratios of greater than 80 percent at origination
2 without private mortgage insurance or government guarantees expose the
3 Company to greater credit risk than home loans with loan-to-value ratios of 80
4 percent or less at origination.

5 * * *

6 Typically, borrowers requesting financing with loan-to-value ratios of greater than
7 80 percent without government guarantees are required to purchase private
8 mortgage insurance [“PMI”] from a third party. In the event of default, the
9 Company can recover losses from the private mortgage insurer. Alternatively,
10 under certain loan programs, qualifying customers can elect to pay a higher
11 interest rate to the Company in lieu of paying for private mortgage insurance. This
12 higher interest rate is expected to compensate the Company for the incremental
13 credit risk inherent in lending to borrowers without private mortgage insurance.

14 Therefore, lower LTV ratios significantly increase credit risk by allowing lenders to avoid
15 purchasing PMI or paying a higher interest rate that would have resulted from a true, higher LTV
16 ratio.

17 74. Prior to hiring outside firms to conduct appraisals on its behalf, WaMu
18 maintained its own department of in-house staff appraisers. Recognizing the dependence of the
19 “soundness of [WaMu’s] mortgage loans and real estate investments” on WaMu’s appraisals,
20 WaMu’s directors and officers supposedly maintained policies to ensure that the appraisals
21 complied with professional standards.

22 75. In addition, on March 22, 2005, federal regulators – including the Office of Thrift
23 Supervision (“OTS”), which regulates WaMu – published guidance directly applicable to WaMu
24 on appraisals, entitled “Frequently Asked Questions on the Appraisal Regulations and the
25 Interagency Statement on Independent Appraisal and Evaluation Functions” (the “2005
26 Interagency Appraisal Guidelines”). OTS also sent a letter to the Chief Executive Officers of the
27 institutions that it regulated, including WaMu, enclosing the 2005 Interagency Appraisal
28 Guidelines. The OTS Letter stated, in relevant part:

Savings associations’ board of directors and management should review the [2005
Interagency Appraisal Guidelines] in conjunction with the OTS appraisal
regulations, the Interagency Appraisal and Evaluation Guidelines (October 1994),
and the Interagency Statement on Independent Appraisal and Evaluation
Functions (October 2003). Internal policies and procedures should ensure that,
among other considerations, the savings association’s appraisal and evaluation
function is safeguarded from internal influence and interference from the loan
production staff.

1 Thus, WaMu and the Officer Defendants, among other WaMu senior executives and directors,
2 knew and understood their obligations to ensure that WaMu was conducting fair and accurate
3 appraisals.

4 76. Moreover, the Interagency Statement on Independent Appraisal and Evaluation
5 Functions (October 2003) that is directly referenced in 2005 Interagency Appraisal Guidelines, in
6 a section entitled “Appraisal and Evaluation Compliance Reviews,” warns that:

7 An institution’s appraisal and evaluation program must maintain effective internal
8 controls that promote compliance with program standards and the agencies’
9 appraisal regulations and Guidelines. Internal controls should, among other
10 criteria, confirm that appraisals and evaluations are reviewed by qualified and
adequately trained individuals who are not involved in the loan production
processes.

11 77. Similarly, the Interagency Appraisal and Evaluation Guidelines (October 1994)
12 that are specifically referenced in the 2005 OTS Cover Letter, state in a section titled
13 “Independence of the Appraisal and Evaluation Function,” that: “Because the appraisal and
14 evaluation process is an integral component of the credit underwriting process, it should be
15 isolated from influence by the institution’s loan production process.”

16 78. Despite these clear guidelines, WaMu utilized in-house appraisers to perform
17 appraisals on properties for which WaMu originated loans. WaMu’s in-house appraisal
18 functions raised concern from federal regulators because, as apparent from the 2005 Interagency
19 Appraisal Guidelines discussed above, banks and other lending institutions that both originated
20 and issued appraisals for the same loans faced potential conflicts of interest concerning appraisal
21 values.

22 79. This concern was particularly warranted with respect to WaMu, as the Officer
23 Defendants’ policies caused appraisal values generated by WaMu’s in house appraisers to be
24 artificially inflated. Starting in July 2006, WaMu outsourced the vast majority of its residential
25 lending appraisal work to two purportedly-independent appraisal companies, eAppraiseIT and
26 LSI, supposedly to protect the integrity of the appraisal process and eliminate the avenues that
27 had previously existed to inflate appraisal values when conducted “in-house” at WaMu.

1 80. Thereafter, both eAppraiseIT or LSI received appraisal orders from WaMu, they
2 were then supposed to select an independent appraiser, provide the necessary information to the
3 appraiser, and report the impartial results to WaMu once the appraisal was complete. However,
4 WaMu required that eAppraiseIT and LSI use only appraisers for WaMu loans from a pre-
5 selected, list created by WaMu sales personnel. In return, eAppraiseIT performed at least
6 260,000 appraisals for WaMu at a cost of \$50 million.

7 81. WaMu, pressured appraisers to “hit” the higher appraisal values that WaMu and
8 its loan production team desired, frequently requested reconsideration of value (“ROVs”), and
9 refused to work with licensed appraisers who were not on the “preferred” appraiser lists.

10 82. The Officer Defendants also caused WaMu’s underwriting standards to
11 deteriorate. Underwriting is a critical component of every loan, because it acts as a form of
12 quality control by which the loan originator is able to enforce its policies for approving or
13 disapproving loans pursuant to its guidelines. WaMu did not disclose the specifics of its
14 underwriting guidelines to the investing public, but instead treated such information as
15 proprietary.

16 83. Nevertheless, the Officer Defendants regularly discussed WaMu’s purportedly
17 strong underwriting standards in public filings, earnings calls, and investor conferences. In
18 particular, Defendants misrepresented that the Company’s underwriting for its “prime” loans was
19 strong and that the Company took great care to confirm the credit-worthiness of its Option ARM
20 and subprime borrowers. For example, in the Company’s 2005 and 2006 Forms 10-K, the
21 Company stated: “[t]he Company seeks to mitigate the credit risk in this portfolio by ensuring
22 compliance with underwriting standards on loans originated to subprime borrowers and by re-
23 underwriting all purchased subprime loans.” Similarly, in speaking of the Company’s Option
24 ARM portfolio, the Officer Defendants claimed that “The Company actively manages the credit
25 risk inherent in its Option ARM portfolio primarily by ensuring compliance with its underwriting
26 standards, monitoring loan performance and conducting risk modeling procedures.” The Officer
27 Defendants repeatedly stated that “[c]redit quality continues to surpass [the Officer Defendants’]
28 expectations,” that the Company maintained “disciplined credit underwriting.”

1 84. WaMu also noted its supposed adherence to “Responsible Residential
2 Lending Principles” that WaMu had formulated in 2001. These Principles, which WaMu
3 distributed publicly through its website and other media, announced that WaMu “is committed to
4 . . . setting the highest standards for responsible lending” that WaMu “only extend[s] credit to
5 borrowers who have demonstrated to us the ability to repay the loan.”

6 85. However, WaMu abandoned appropriate underwriting standards for its loans
7 in favor of underwriting policies designed to allow WaMu to increase the volume of loans it
8 could originate and inflate the Company’s earnings.

9 86. For example, the Officer Defendants consistently emphasized to the public that
10 the Company’s “prime” loans were of “high quality.” At the Company’s 2006 Investor Day held
11 in September 2006, Defendant Cathcart claimed the Company had “maintained conservative
12 lending standards” in the Company’s prime and home equity portfolios that resulted in “high
13 quality loans.”

14 87. WaMu also regularly distinguished between its “prime” and “subprime” loans.
15 For example, the Company reported its volumes of prime and subprime mortgage loans produced
16 and sold, the volumes of prime and subprime loans held for investment, and the value of the
17 Company’s credit-sensitive retained (or “residual”) interests in securitized prime and subprime
18 loans. However, WaMu did not adhere to industry standards for classifying loans.

19 88. The most widely accepted measure of creditworthiness is the borrower’s
20 Fair Issac Credit Organization (“FICO”) credit score. FICO scores are key determinants of
21 whether a given borrower will be classified as “prime” or “subprime.” Fitch Ratings termed
22 FICO scores the “best single indicator” of mortgage default risk. In its 2005 Amended Form 10-
23 K, WaMu said that credit scores are “a useful measure for assessing the credit quality of a
24 borrower” and one of two key determinants “in forecasting future loan performance” (along with
25 the loan’s LTV ratio).

26 89. A FICO score which can range from 300 to 850, is calculated based on payment
27 history, amounts owed to creditors, length of credit history, new credit sources, and types of
28 credit used. Generally, the higher the FICO score, the better the borrower’s credit and the lower

1 the risk of default. According to Fair Isaac, approximately 27% of the U.S. population has a
2 FICO score between 750 and 799, 27% has a score below 650, and 15% has a score below 600.

3 90. According to the Expanded Guidance for Subprime Lending Programs, issued
4 jointly by the Officer of the Comptroller for Currency, the Federal Reserve Board, the Federal
5 Deposit Insurance Corporation and the Officer of Thrift Supervision on February 2, 2001,
6 subprime borrowers generally have a FICO score of 660 or below. This Expanded Guidance was
7 sent to CEOs such as WaMu CEO Defendant Killinger by both the FDIC and the OTS. The
8 Expanded Guidance lists various credit characteristics of subprime borrowers, including:
9 payment delinquencies, charge-offs, judgments and bankruptcies. Such borrowers “may also
10 display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other
11 criteria that may encompass borrowers with incomplete credit histories.” Subprime loans “have
12 a higher risk of default than loans to prime borrowers.” Accordingly, the Expanded Guidance
13 states that loans should be classified as subprime in accordance with the guidelines and other
14 applicable Agency guidelines.

15 91. Other recognized industry sources recognize similar thresholds. Standard &
16 Poor’s, one of the leading securities rating agencies, stated that it considered “prime borrowers to
17 have a FICO credit score of 660 or above.” Freddie Mac stated that “FICO scores are an
18 effective tool in evaluating a Borrower’s credit reputation . . . Freddie Mac has identified a strong
19 correlation between Mortgage performance and FICO scores.” For single-family homes, Freddie
20 Mac views a FICO score of 660 or above as “likely to have an acceptable credit reputation.” A
21 FICO score of 620 to 660 is viewed as “an indication that the Borrower’s willingness to repay
22 and ability to manage obligations as agreed are uncertain.” A FICO score of below 620 “should
23 be viewed as a strong indication that the Borrower’s credit reputation is not acceptable[.]”

24 92. Washington Mutual repeatedly stated that its prime loan borrowers had high FICO
25 scores. For example, during WaMu’s 2006 Investor Day Conference held on September 7, 2006,
26 Defendant Cathcart stated that the home equity portfolio, primarily generated through retail
27 banking channels, has an average FICO score at origination of 734. Defendant Cathcart also said

1 that the Option ARM loan product, which is “not made available to subprime borrowers,” had a
2 weighted average FICO score of 708.

3 93. WaMu’s claims of high FICO scores for its prime home equity portfolio and
4 Option ARMs continued throughout 2006 and 2007. During the WaMu Brothers 10th Annual
5 Financial Services Conference on May 16, 2007, Defendant Killinger reported that the prime
6 residential portfolio, two-thirds of which is Option ARM loans, had an average FICO score of
7 708. The Option ARM customers reportedly had an average FICO score of 700.

8 94. Moreover, because WaMu’s Option ARM loans were of particular concern to
9 investors who wanted to make certain that the Company was not underwriting high-risk loans,
10 Defendants regularly reassured investors of the strength of the Company’s underwriting for
11 Option ARM loans. In specifically addressing concerns about the Company’s Option ARM
12 portfolio, Defendant Cathcart stated during WaMu’s 2006 Investor Day, “At origination, WaMu
13 focuses on an effective underwriting process and borrower disclosures through our experienced
14 sales force and broker channels.”

15 95. Defendants also stated, that the Company underwrote its Option ARM loans to
16 the fully-indexed rate, thus helping to prevent payment shock when the “teaser” rate ended. For
17 example, during a January 18, 2006 earnings call Defendant Rotella emphasized that “an
18 important fact is we underwrite every loan at the fully indexed rate. And so that’s an important
19 thing to note from a credit perspective.” At a November 16, 2006 investors conference
20 Defendant Killinger stated: “Our option ARM portfolio quality is also very good This
21 quality reflects the option ARM underwriting which evaluates the borrower’s ability to make the
22 loans’ fully amortizing payments, even though they are allowed to make a much lower initial
23 payment. . . . Let me make one clear point. In our underwriting on option ARMs we underwrite
24 to the fully indexed rate, we never underwrite to the teaser rate. And so, again, we don’t see this
25 as having a significant impact on the underwriting for us.”

1 96. WaMu made loans to “subprime” borrowers through its subprime channel, LBM.
2 In 2006, LBM was consolidated into the Home Loans Group, and Company’s subprime lending
3 (formerly LBM) was referred to in the Company’s SEC filings as WaMu’s “specialty mortgage
4 finance operations.” This reorganization did not modify WaMu’s subprime lending practices.

5 97. Although WaMu did not define “subprime” borrowers, subprime loans are
6 generally made to borrowers with lower FICO scores who could not normally obtain prime loans.
7 Because subprime borrowers’ credit scores indicated that they were less creditworthy than
8 WaMu’s “prime” borrowers, WaMu was able to charge much higher interest rates and fees on
9 these subprime loans. However, WaMu also assured investors that although loans were being
10 made to borrowers with low FICO scores, the Company’s purportedly rigorous underwriting
11 standards guarded against excessive credit risk to the Company. For example, the Company’s
12 Amended 2005 Form 10-K announced that, “[t]he Company seeks to mitigate the credit risk in
13 [WaMu’s subprime] portfolio by ensuring compliance with underwriting standards on loans
14 originated to subprime borrowers and by re-underwriting all purchased subprime loans.” As set
15 forth below, WaMu made a similar reassurance in its 2006 Form 10-K.

16 98. Furthermore, in July 2006, Defendant Rotella claimed that with regard to the
17 Company’s subprime lending, “we’re being quite careful and making any changes we need to
18 make in our credit policies as we move forward, but our sense of things are – things are in pretty
19 good shape.” At WaMu’s 2006 Investor Day, in September 2006, Defendant Schneider claimed
20 that:

21 On subprime, we have seen, as others have seen, some early payment default and
22 repurchase activity. We saw most of that occur for us in late ‘05, Q4 ‘05, and first
23 quarter of ‘06. We reserved for it appropriately and we have also, in second
24 quarter of ‘06, tightened up a number of our underwriting guidelines, and you
25 can see that in our numbers.

26 In fact, we think we’ve lost probably a percentage or so of market share over the
27 past year as a result of tightening some of the credit guidelines in our subprime
28 business. And we think that was the prudent thing to do and actually we think
we’re ahead of many of our competitors here.

1 99. The FDIC issued specific warnings regarding subprime lending to mortgage
2 lenders. For example, in 1999, the Office of the Comptroller of the Currency, the Federal
3 Reserve Board, the Federal Deposit Insurance Corporation, and the OTS jointly issued the
4 Interagency Guidance on Subprime Lending, which gave extensive guidance to subprime lenders
5 regarding risk management and appropriate credit loss reserving. The guidance noted, “If the
6 risks associated with this activity are not properly controlled, the agencies consider subprime
7 lending a high risk activity that is unsafe and unsound.”

8 100. However, as discussed above, the Individual Defendants failed to implement or
9 enforce subprime lending guidelines, allowing WaMu employees to consummate more and more
10 subprime loans.

11 101. As a result of the conduct described above, WaMu published financial statements
12 and information that violated generally accepted accounting principles (“GAAP”) and failed to
13 disclose the true financial condition of the Company.

14 102. For example, GAAP required WaMu and the Officer Defendants to establish a
15 reserve for incurred credit losses resulting from borrowers defaulting on their obligations to make
16 monthly mortgage payments or when it was probable that borrowers would do so. WaMu
17 referred to this loss reserve as its Allowance for Loan and Lease Losses (“Allowance”).

18 103. WaMu’s Allowance was a critical metric for investors, for which management
19 was directly responsible. As described in a December 2006 “Interagency Policy Statement on
20 the Allowance for Loan and Lease Losses,” issued jointly by the Office of the Comptroller of the
21 Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance
22 Corporation (“FDIC”), the National Credit Union Administration, and the OTS (collectively, the
23 “Agencies”):

24 The [Allowance] represents one of the most significant estimates in an
25 institution’s financial statements and regulatory reports. Therefore, each financial
26 institution has a responsibility for ensuring that controls are in place to
27 consistently determine the [Allowance] in accordance with GAAP, the
28 institution’s stated policies and procedures, and relevant supervisory guidance.

104. Indeed, the Company’s 2006 Form 10-K explained, “[t]he [Allowance] represents
management’s estimate of incurred credit losses inherent in the Company’s loan and lease

1 portfolios as of the balance sheet date.” Not surprisingly, the Officer Defendants consistently
2 touted the soundness of WaMu’s Allowance. For example, during a May 18, 2006 conference
3 call, Defendant Killinger announced: “The next target is on the credit front. . . . Certainly we can
4 come back in the Q&A if you want to talk more about credit; but credit for us is [in] excellent
5 shape, and I feel very comfortable with where we are from management of that credit as well as
6 the reserving.”

7 105. The Allowance was reported on the Company’s balance sheet as a reduction to
8 assets. As loans were “charged off” as losses against the Allowance, the Allowance was reduced.
9 In order to properly account for the worsening credit quality of its loan portfolio, WaMu was
10 required under GAAP to record periodic provisions (which WaMu referred to as its “provisions
11 for loan and lease losses” or its “provision for loan losses”) to increase its reserve to reflect its
12 estimate of incurred or probable credit losses. Under GAAP, a provision for loan and lease
13 losses is recorded as an expense, which reduces pre-tax earnings on a dollar-for-dollar basis.
14 Thus, WaMu’s reported Allowance was directly linked to net income and the Company’s
15 earnings per share.

16 106. However, WaMu failed to properly account for and disclose its Allowances.
17 Rather, to conceal the negative impact that the deteriorating credit quality of the Company’s
18 home mortgage loans was having on the Company’s financial condition, WaMu and the Officer
19 Defendants, among other things, improperly accounted for the impairment of WaMu’s loan
20 portfolio by materially understating WaMu’s provisioning for loan and lease losses, and thereby
21 overstated WaMu’s net income and earnings per share and understated WaMu’s Allowance.

22 107. WaMu repeatedly represented that it accounted for its Allowance for its portfolio
23 of home mortgage loans in accordance with GAAP, and, in particular, Statement of Financial
24 Accounting Standards No. 5, “Accounting for Contingencies” (“SFAS 5”). SFAS 5, which was
25 issued over thirty years ago, states:

26

27

28

1 An estimated loss for loss contingency . . . shall be accrued by a charge to income
2 if *both* of the following conditions are met:

- 3 a. Information available prior to issuance of the financial statements
4 indicates that it is probable that an asset had been impaired or a liability
5 had been incurred at the date of the financial statements. It is implicit in
6 this condition that it must be probable that one or more future events will
7 occur confirming the fact of the loss.
- 8 b. The amount of loss can be reasonably estimated.

9 (Emphasis in original.)

10 108. In the context of lending, Statement of Financial Accounting Standards No. 114,
11 “Accounting By Creditors for Impairment of a Loan” (“SFAS 114”), which was issued in May
12 1993 – over fifteen years ago – provides a definition of “impairment” for individual loans under
13 GAAP that is also instructive for pooled loans: “A loan is impaired when, based on current
14 information and events, it is probable that a creditor will be unable to collect all amounts due
15 according to the contractual terms of the loan agreement.”

16 109. Further, the American Institute of Certified Public Accountants’ (AICPA) *Audit*
17 *and Accounting Guide for Depository and Lending Institutions: Banks and Savings Institutions,*
18 *Credit Unions, Finance Companies and Mortgage Companies* (the “AICPA Guide”), which was
19 originally issued in 2004 and updated in 2007, states: “if a faulty credit granting decision has
20 been made or loan credit review procedures are inadequate or overly aggressive . . . the loss
21 should be recognized at the date of loan origination.”

22 110. These fundamental GAAP provisions underpin the “Expanded Guidance for
23 Subprime Lending Programs,” issued by the Agencies in 2001, which provided guidance specific
24 to reserving for subprime loans:

25 The [Allowance] required for subprime loans should be sufficient to absorb at
26 least all estimated credit losses on outstanding balances over the current operating
27 cycle, typically 12 months. The board of directors and management are
28 expected to ensure that the institution’s process for determining an adequate
level for the [Allowance] is based on a comprehensive and adequately
documented analysis of all significant factors. The consideration of factors
should include historical loss experience, ratio analysis, peer group analysis,
and other quantitative analysis, as a basis for the reasonableness of the
[Allowance]. To the extent that the historical net charge-off rate is used to
estimate expected credit losses, it should be adjusted for changes in trends,
conditions, and other relevant factors, including business volume, underwriting,
risk selection, account management practices, and current economic or business

1 conditions that may alter such experience. The allowance should represent a
2 prudent, conservative estimate of losses that allows a reasonable margin for
imprecision.

3 111. The SEC also provides direct guidance on the proper accounting for loan losses.
4 SEC Staff Accounting Bulletin No. 102, “Selected Loan Loss Allowance Methodology and
5 Documentation Issues” (“SAB 102”), which was issued in July 2001, states in pertinent part: “It
6 is critical that loan loss allowance methodologies incorporate management’s current judgments
7 about the credit quality of the loan portfolio through a disciplined and consistently applied
8 process.” Therefore, pursuant to SAB 102, a loan loss allowance methodology generally should
9 “[c]onsider all known relevant internal and external factors that may affect loan collectability . . .
10 [and] be based on current and reliable data[.]” The Officer Defendants failed to appropriately
11 take into account these factors in provisioning for the Company’s Allowance.

12 112. The SEC further states in SAB 102 that “[f]or many entities engaged in lending
13 activities, the allowance and provision for loan losses are significant elements of the financial
14 statements. Therefore, the staff believes it is appropriate for an entity’s management to review,
15 on a periodic basis, its methodology for determining its allowance for loan losses.” Thus, in
16 addition to evaluating loans for impairment at origination, lenders are expected to reevaluate
17 their reserving methodology and loan portfolios for impairment every financial reporting period.

18 113. WaMu, Deloitte, and the Officer Defendants concealed their material deviations
19 from these accounting standards and falsely described the Company’s Allowance. WaMu
20 represented that it was following appropriate accounting rules and that, among other things, the
21 Company’s management reviewed its models for loan losses for reasonableness, and, on a
22 quarterly basis, updated the assumptions used in those models. In addition, according to the
23 Company’s 2006 Form 10-K, WaMu supposedly evaluated for impairment its loans held in
24 portfolio on a collective basis “using statistical forecasting models that estimate default and loss
25 outcomes based on an evaluation of past performance of loans in the Company’s portfolio and
26 other factors as well as industry historical loan loss data.” Based on this statistical modeling, the
27 Company represented, WaMu allocated a certain percentage of its provision for loan losses to its
28 different loan product categories (*e.g.*, home loans, credit card loans, commercial loans).

1 114. Additionally, the allocated portion of WaMu's Allowance was supplemented by
2 an unallocated allowance, which, according to WaMu, was supposedly based upon several
3 factors, including "national and local economic trends and conditions, industry conditions within
4 portfolio segments, recent loan portfolio performance, loan growth and concentrations, changes
5 in underwriting criteria, and the regulatory and public policy environment." Defendant Killinger
6 stated in a December 13, 2006 conference call with investors:

7 When we do our reserving, I will tell you that we factor in the existing book of
8 business; what the current delinquencies are; we make assumptions about housing
9 price declines and the economy; and we develop models about what we think is
10 going to happen to delinquencies, ultimate charge-offs. And those things are,
11 clearly, rising right now. And then we back that into what's the appropriate
12 amount of embedded losses in that portfolio, and that determines our reserving.
13 We do that every quarter.

14 115. According to the Company's 2006 Form 10-K, the Finance Committee of
15 the Company's Board of Directors oversaw the Company's credit risk management activities,
16 including Defendants Frank and Reed. Further, according to the Company's 2006 Form 10-K,
17 the Company's Enterprise Risk Management Committee, which was chaired by the Company's
18 Chief Enterprise Risk Officer, Defendant Cathcart, was responsible for "oversee[ing] the
19 identification, measurement, monitoring, control and reporting of credit, market and operational
20 risks." The Company's 2006 Form 10-K explained that:

21 Enterprise Risk Management works with the lines of business to establish
22 appropriate policies, standards and limits designed to maintain risk exposures
23 within the Company's risk tolerance. Significant risk management policies
24 approved by the relevant management committees are also reviewed and
25 approved by the Board, Audit, and Finance Committees.

26 Thus these Officer and Director Defendants knew that the Company had become more aggressive
27 in its credit provisioning, and were failing to accurately report WaMu's Allowance.

28 116. The deterioration of the credit quality of WaMu's loans was neither outside of the
29 Company's control nor was it unforeseeable to management. Indeed, WaMu increasingly
30 underwrote high-risk loans with loose underwriting standards and inflated appraisals, which it
31 knew were impaired, while under-provisioning its Allowance. For example, the Company
32 increased the proportion of Option ARM loans in its home loan portfolio without adjusting its
33 Allowance appropriately. Indeed, the Company encouraged its salespeople and mortgage brokers

1 with whom the Company worked to sell ever greater numbers of Option ARM loans through
2 bonus incentives. Option ARM loans dominated WaMu's single-family residential portfolio.

3 117. WaMu recorded significant amounts of negative amortization (*i.e.*, the
4 difference between the payment made and the full payment to pay all interest due) from Option
5 ARMs as deferred revenue (*i.e.*, interest income) and increased the balance due on negatively-
6 amortizing loans.

7 118. The reported increase in interest income from negative amortization
8 presented the impression that the Company's results were strong. In fact, the enormous
9 accumulated negative amortization on these loans was a red flag to the Officer Defendants that
10 those loans were trending towards delinquency and default.

11 119. Similarly, the Officer Defendants did not adequately consider the Company's
12 "levels of and trends in delinquencies and impaired loans" in provisioning for loan losses. The
13 quality of the Company's loan portfolio was steadily worsening over time, illustrated by the
14 rising number of "nonaccrual loans," or home mortgage loans that were over ninety days past due
15 on payments. Instead of increasing the Allowance in compliance with GAAP to properly account
16 for the deteriorating quality of WaMu's loan portfolio, the Officer Defendants actually decreased
17 the Allowance relative to the number of nonaccrual loans that were accumulating in the
18 Company's portfolio, after taking into account one-time events, such as Hurricane Katrina-
19 related costs.

20 **D. 2007: In Midst Of Defendants' Reassurances To Market About WaMu's**
21 **Financial Condition And Risk Management Practices, The County Purchases**
22 **Interest In WaMu Note**

23 120. On January 17, 2007, WaMu issued a press release announcing its financial
24 results for the quarter and year-ended December 31, 2006. WaMu reported that, for the fourth
25 quarter 2006, the Company had a net income of \$1.06 billion, compared with net income of \$865
26 million in the fourth quarter of 2005. For the full year 2006, the Company's reported net income
27 was \$3.56 billion, compared with a net income of \$3.43 billion, in 2005. WaMu also reported
28 that its provision for loan and lease losses for the fourth quarter 2006 was \$344 million, \$95
million of which the Company attributed to the Company's on balance sheet credit card

1 receivables. For the full-year 2006, the Company reported a loan loss provision of \$816 million,
2 an increase of \$500 million over 2005, which the Company stated in its earnings release was
3 “primarily due to the addition of the company’s credit card business acquired Oct. 1, 2005.”
4 Defendant Killinger stated that the Company’s “outlook for 2007 reflects the strategic actions we
5 took in 2006 to prepare the company for the future. Those decisive actions have positioned us
6 well to deliver stronger operating performance in 2007.”

7 121. That same day, the Company held an earnings call with investors to discuss the
8 fourth quarter and year-end 2006 results. While the Officer Defendants noted the difficult
9 environment for mortgage lenders, Defendant Killinger emphasized the Company’s efforts to
10 prepare for such times:

11 As you’ll recall I have been pretty pessimistic on the housing market for the last
12 couple of years, and really felt that the market was overheated and was likely to
13 be slowing at some point, and so both the combination of that and also from a
14 strategic standpoint we’ve been diversifying our mix of businesses . . . We
15 tightened underwriting, we decreased production volume by about half in the
16 subprime area taking ourselves down from the sixth largest originator all the way
17 down to ten, and we decreased the subprime portfolio you were asking about by
18 about \$2.4 billion over the last twelve months, and I think the important thing is
19 that as the housing market has softened as expected, what I have really seen is a
20 continued very good performance out of most parts of the portfolio.

21 Defendant Killinger reassured investors that, although the Company had stated its intention to
22 focus on higher-margin mortgage products in the past, it had promised to do so only in a
23 “prudent manner.” Defendant Killinger also announced that the Board was raising the quarterly
24 dividend for the 46th consecutive quarter. The stock price of the Company’s common shares
25 rose from a close of \$44.06 on January 16 to \$45.31 on January 26.

26 122. On January 30, 2007, Defendant Killinger appeared at the Citigroup 2007
27 Financial Services Conference and told investors that the credit quality of the Company’s loan
28 portfolio “continue[d] to be in very good shape.” Killinger noted the “high quality” of the
29 Company’s prime loans, the “very good” quality of the Option ARM portfolio, and the “very
30 high quality” of the home equity portfolio. Killinger then attributed the high credit quality of
31 these loans to the low LTV ratios associated with those loan portfolios. Killinger underscored
the Company’s “rigorous adher[ence] to [its] minimum FICO threshold” in its subprime portfolio

1 and, in response to a question regarding the Company's charge-offs in its subprime portfolio,
2 downplayed the importance of the charge-offs, explaining that the Company's subprime portfolio
3 had been decreasing in size and claiming that "when you're not originating new ones at the same
4 level and are letting the portfolio run up, you get a natural increase in [charge offs]."

5 123. On March 1, 2007, WaMu filed with the SEC a Form 10-K for the fourth
6 quarter and fiscal year ended December 31, 2006 (the "2006 Form 10-K"). The 2006 Form 10-K
7 was signed by Defendants Killinger, Casey, Frank, Leppert, Reed, Smith, Matthews, and
8 Murphy, amongst others, and included Deloitte's unqualified audit opinion on the Company's
9 financial statements and management's assessment of internal controls. Specifically, Deloitte
10 stated:

11 In our opinion, such consolidated financial statements present fairly, in all
12 material respects, the financial position of the Company as of December 31, 2006
13 and 2005, and the results of operations and of its cash flows for each of the three
14 years in the period ended December 31, 2006, in conformity with accounting
15 principles generally accepted in the United States of America. We have also
16 audited, in accordance with the standards of the PCAOB, the effectiveness of the
Company's internal control over financial reporting as of December 31, 2006 . . .
and our report dated February 26, 2007, expressed an unqualified opinion on
management's assessment of the effectiveness of the Company's internal control
over financial reporting and an unqualified opinion on the effectiveness of the
Company's internal control over financial reporting.

17 The Company reiterated the financial results set forth in the January 17, 2007 press release and
18 earnings call, and also reported a full-year provision for loan and lease of \$816 million in 2006,
19 compared with a provision of \$316 million in 2005. According to the 2006 Form 10-K, this
20 higher provision was "substantially the result of the Company's entry into credit card lending that
21 resulted from the Providian acquisition and the ensuing growth in the on-balance sheet credit
22 card portfolio, which accelerated during the fourth quarter of 2006." WaMu also touted the
23 Company's underwriting standards for its Option ARM portfolio, claiming that, "[t]he Company
24 actively manages the credit risk inherent in its Option ARM portfolio primarily by ensuring
25 compliance with its underwriting standards, monitoring loan performance and conducting risk
26 modeling procedures." The Company announced improved credit risk management practices,
27 stating: "In 2006, the Finance Committee of the Board of Directors approved a set of credit risk
28 concentration limits. These limits facilitate a more rigorous and quantitative framework that

1 better enables the credit risk management function to proactively manage credit risk.”

2 Defendants Killinger and Casey signed certifications attesting to the accuracy of the information
3 contained in the 2006 Form 10-K, and the Form 10-K contained a statement confirming the
4 adequacy of the Company’s internal controls over financial reporting.

5 124. Analysts and bond rating agencies alike responded favorably to the Company’s
6 and Deloitte’s statements regarding the Company’s financial condition, credit quality and internal
7 controls. Although all analysts noted the difficult mortgage environment in which the Company
8 operated, the Officer Defendants’ reassurances that the Company had prepared for these negative
9 events by tightening underwriting practices were well-received. For example, Erin Swanson of
10 Morningstar observed that “all is not smooth sailing” given the “softening” in the industry;
11 however, “[t]hat said, we think WaMu’s management team anticipated this slowdown and began
12 taking steps to position its balance sheet for tougher times. During 2006, WaMu sold all of its
13 subprime mortgage originations, tightened its underwriting, and reduced its subprime portfolio
14 by \$2.4 billion.” Swanson raised the fair value estimate of WaMu by \$5 a share. The Company’s
15 stock price also rose from a close of \$44.06 on January 16, 2007, to close at \$45.35 on January
16 24, 2007, an increase of almost 3%.

17 125. On April 17, 2007, WaMu issued a press release announcing its financial results
18 for the quarter ending March 31, 2007, including net income of \$784 million, and total assets of
19 \$319.9 billion. In the press release, Defendant Killinger praised the Company’s performance,
20 stating, “[o]verall, we delivered solid results in the first quarter despite the challenging interest
21 rate environment and slowing housing market.” The Company also reported that its provision for
22 loan and lease losses was \$234 million, down from to \$344 million in the fourth quarter 2006.
23 The Company noted that although the subprime portfolio had deteriorated, the prime portfolio
24 had improved. During an earnings call that same day, Defendant Killinger stated:

25 “While we’re not at our full earnings potential, I am pleased with the solid results
26 delivered by our team, despite a quarter that was challenged by a number of
27 environmental factors. We had an inverted yield curve, and slowing housing
28 markets and unprecedented deterioration in the subprime mortgage business. . . .
In home loans, which felt the brunt of the environmental challenges during the
quarter, we were encouraged by improved performance in our prime lending
business. . . . reflecting these results and the company’s strong financial position,

1 the Board once again increased the quarterly cash dividend, for the 47th
2 consecutive quarter, by \$0.01, to \$0.55 cents per share. . . . [The Company is]
3 seeing encouraging signs with the improvement in the prime business that we saw
4 in the first quarter, and with the steps that we've taken into the subprime area of
5 increasing pricing, improving underwriting, that we are starting to see that show
6 up in the way of early signs of credit on the 2007 production looks much better
7 than '06, so that's encouraging. . . . I would view the first quarter of having been
8 profitable for our prime part of the business. It was offset[,] more than offset[,] by
9 the losses in the subprime area, and as the subprime area comes back to more of a
10 normalcy, I think that we can certainly expect the home loan unit to get back to
11 profitability and the current expectation for us is later in the year, rather than
12 getting specific on one quarter or the other."

13 Similarly, Defendant Casey again highlighted the improved standards supposedly imposed
14 on the Company's subprime channel, stating "With regard to pricing and underwriting standards
15 in the subprime area, as Kerry mentioned, we've been working on this for quite some time.
16 We've reduced our volume significantly and in the first quarter, we have significantly increased
17 our pricing and decreased our risk profile that we're willing to underwrite to, and so we think
18 all those factors taken together will make this business a little more profitable. We are being
19 selective with our underwriting." Defendant Rotella stated: "we have absolutely no
20 plans to shut down our subprime channel. We have, as you've heard, since the beginning of last
21 year been tightening credit in that part of our business. You heard the volume numbers were
22 down 51% year on year and volume and we feel pretty good about the credit box we're playing
23 in right now, but we're cautious as the market goes through this rationalization."

24 126. On May 10, 2007, the Company filed with the SEC a Form 10-Q for the
25 period ending March 31, 2007, which was signed by Defendant Casey (the "First Quarter 2007
26 Form 10-Q"). The First Quarter 2007 Form 10-Q repeated the financial results set forth in the
27 Company's April 17, 2007 press release and earnings conference call, and also stated that "[t]he
28 Company's financial reporting and accounting policies conform to accounting principles
generally accepted in the United States of America ('GAAP')." Defendants Killinger and Casey
signed certifications attesting to the accuracy of the information contained in the First Quarter
2007 Form 10-Q. Additionally, the First Quarter 2007 Form 10-Q contained a statement
confirming the adequacy of the Company's internal controls over financial reporting. The First
Quarter 2007 Form 10-Q again reiterated the Company's stated belief that "loan-to-value ratios

1 are one of the two key determinants in determining future loan performance.” In response, the
2 Company’s stock price rose from a close of \$40.73 on April 16, 2007, to close at \$42.77 on April
3 20, 2007, an increase of 5%.

4 127. On July 11, 2007, in reliance on Defendants’ misrepresentations and omissions,
5 which were also reflected in the high ratings and market price for the notes, the County
6 purchased a substantial interest in a three-year WaMu note, with a maturity date on May 1, 2009.
7 The par amount of the note was \$20,000,000.00 with a 5.44625% coupon. At the time of the
8 purchase, the note was rated A1 by Moody’s, A by Fitch, and A by Standard and Poors. The
9 County made its decision to purchase the WaMu note in California and, at all times, held the note
10 in its custodial account in California.

11 128. On July 18, 2007, WaMu issued a press release announcing its financial results
12 for the quarter ending June 30, 2007, reporting that, for the second quarter 2007, the Company
13 had net income of \$830 million, and total assets of \$312.2 billion. Defendant Killinger praised
14 the performance, stating, “We delivered record growth in our retail banking, credit card and
15 commercials businesses during the second quarter. Our Home Loans’ results improved from the
16 first quarter and we are targeting a return to profitability by the end of the year.” The Company
17 also reported that its provision for loan and lease losses was \$372 million, up from \$234 million
18 in the second quarter 2007. The Company noted that the performance of the Company’s home
19 loans portfolio had improved over the second quarter, stating that “Home Loans shows
20 improvement in a difficult environment,” and “Prime business continues to improve.”
21 That same day, the Company held an earnings call and Defendant Killinger announced, “We
22 also saw improvement in the performance of our home loans group, despite continued pressure
23 from the challenging rate environment and ongoing weakness in the subprime mortgage market
24 as well as continued erosion in the housing market.” Defendant Casey stated, “While we
25 anticipate that we will see higher [nonperforming assets] across all of our home loan portfolios,
26 we expect losses in the prime loans to be much lower due to the lower LTVs and high FICO
27 profile of our prime portfolio.” Defendant Killinger touted the Company’s role in the industry
28 with regard to underwriting standards, stating:

1 From my point of view, I think too much money, and some would say just
2 irrational money, did flood the mortgage market, particularly in the subprime area
3 over the last two years, and I think this caused underwriting standards to decline,
4 credit spreads to narrow, volumes to surge, and now not unexpectedly
5 delinquencies and losses to sore. This was a real concern of ours, and where we
6 took a lot of defensive actions beginning about two years ago, like tightening
7 underwriting, selling off our '04 and '05 residuals, delayed our plans to grow the
8 subprime portfolio, . . . I think now what we're seeing is, some underwriting
9 discipline starting to return, credit spreads are widening, and marginal players are
10 leaving the industry. And I think that this gives us an opportunity to gradually
11 increase our loan portfolios, with much improved risk adjusted returns. So I think
12 – I do think we're watching the subprime area very carefully. We think the
13 industry has a lot more to go in terms of tightening underwriting to be appropriate
14 for today's underwriting environment. That's why I mentioned the initiatives that
15 we have taken to help lead the industry to what we think is much more prudent
16 and appropriate underwriting standards at this point in the cycle. In assuming we
17 start to see credit quality improve because of these underwriting initiatives, and if
18 we see credit spreads widen and good opportunities to take assets in our portfolio,
19 we would like to start accelerating the – the growth of our balance sheet again.

11 129. On August 9, 2007, the Company filed with the SEC a Form 10-Q for the
12 period ending June 30, 2007, which was signed by Defendant Casey (the "Second Quarter 2007
13 Form 10-Q"). The Second Quarter 2007 Form 10-Q repeated the financial results set forth in the
14 Company's July 18, 2007 press release and earnings conference call and stated that "[t]he
15 Company's financial reporting and accounting policies conform to accounting principles
16 generally accepted in the United States of America ('GAAP')." Defendants Killinger and Casey
17 signed certifications attesting to the accuracy of the information contained in the Second Quarter
18 2007 Form 10-Q. Additionally, the Second Quarter 2007 Form 10-Q contained a statement
19 confirming the adequacy of the Company's internal controls over financial reporting.

20 130. On September 10, 2007, Defendants Killinger and Casey attended the WaMu
21 Brothers 5th Annual Financial Services Conference. Defendant Killinger continued to falsely
22 assure investors that for "over two years" the Company had been taking "proactive steps" to
23 prepare for a decline in housing prices, including "a series of major underwriting changes in our
24 home loans lending guidelines." Defendant Killinger also touted the Company's low LTV ratios
25 in its home loan portfolio and the "attractive" returns seen on Option ARM loans and other
26 adjustable rate mortgages, noting that "the credit quality in these loans is good." However,
27 Killinger revealed that, while he was not updating the Company's guidance, the Company
28 anticipated that the provision for loan losses for 2007 "could be approximately \$500 million

1 greater” than the full year guidance the Company provided in July 2007 (\$1.5 billion to \$1.7
2 billion). Defendant Killinger attributed this to a “near perfect storm” in housing conditions and
3 rising interest rates. Killinger reassured investors that WaMu was taking “proactive steps” and
4 that general conditions were to blame for the Company’s anticipated heightened provision for
5 loan and lease losses. In response, WaMu’s stock price rose from a closing price of \$34.74 per
6 share on September 10, 2007 to a closing price of \$38.32 per share on September 19, 2007.

7 131. On October 5, 2007, the Company issued a press release entitled “Washington
8 Mutual Q3 Net Income Impacted by Market and Credit Environments,” including the Company’s
9 third quarter 2007 results. WaMu disclosed that the Company’s net income for the quarter would
10 decline by approximately 75% from the same quarter during the prior year due to “a weakening
11 housing market and disruptions in the secondary market.” WaMu also said the Company’s loan
12 loss provision for the third quarter was expected to increase to approximately \$975 million due to
13 “ongoing weakness in the housing market, primarily as it affects subprime and home equity
14 loans, as well as growth in the company’s loan portfolio.” Nonetheless, Killinger reassured
15 investors about the Company’s financial position, explaining that WaMu expected improved
16 results the following quarter: “While we’re disappointed with our anticipated third quarter
17 results, we look forward to an improved fourth quarter as we continue to see good operating
18 performance in our Retail Banking, Card Services and Commercial Group businesses.” Based on
19 Killinger’s assurances, WaMu’s stock price rose from \$35.06 per share on October 5, 2007 to
20 \$35.61 per share on October 8, 2007.

21 132. On November 9, 2007, the Company filed with the SEC a Form 10-Q for the
22 quarter ended September 30, 2007 (the “Third Quarter 2007 Form 10-Q”), which was signed by
23 Defendant Casey and included certifications by Defendants Killinger and Casey. The Third
24 Quarter 2007 Form 10-Q repeated the financial results set forth in the Company’s October 17,
25 2007 press release, including that the Company’s provision for loan and lease losses was \$967
26 million for the quarter. The Third Quarter 2007 Form 10-Q continued to conceal the Company’s
27 improper lending, and accounting practices and deficient risk management. It also failed to
28 disclose the true extent of the Company’s loss exposure.

1 133. On January 17, 2008, after the close of the market, the Company announced its
2 earnings for the quarter and year ended December 31, 2007, as well as a dividend of \$0.15 per
3 share. In an analyst conference call, Defendants Killinger, Casey and Rotella again blamed the
4 Company's financial performance on the "turmoil" and "unprecedented challenges in the
5 mortgage and credit markets," and not the Company's improper lending and accounting practices
6 and deficient risk management. Defendants continued to conceal the full magnitude of the
7 Company's loss exposure and the full size of the Company's loan loss provision that was yet to
8 be recorded.

9 134. On February 29, 2008, the Company filed with the SEC its Form 10-K for the
10 year ended December 31, 2007, which was signed by, among others, Defendants Killinger and
11 Casey, and included certifications by Defendants Killinger and Casey. On May 22, 2008, the
12 Company filed with the SEC its Form 10-K/A for the year ended December 31, 2007
13 (collectively, the "2007 Form 10-K"). The 2007 Form 10-K repeated the financial results set
14 forth in the Company's January 17 press release, and continued to conceal the Company's
15 improper lending, and accounting practices and deficient risk management practices as well as
16 the true extent of the Company's loss exposure.

17 135. On March 14, 2008, Moody's downgraded the Company's senior unsecured debt
18 rating from Baa2 to Baa3, one level above junk status. In lowering its rating, Moody's explained
19 that it "believes that remaining lifetime losses on [WaMu's residential mortgage loan] portfolio
20 will be higher than previously expected" and that "WaMu's required provisioning is likely to be
21 greater than \$12 billion and that full year 2008 net losses could eliminate the company's
22 approximately \$6 billion capital cushion above regulatory well capitalized minimums." Moody's
23 also placed a negative outlook on all WaMu entities.

24 136. On April 7, 2008, private equity firm TPG reportedly was close to a deal to invest
25 \$5 billion in WaMu in order for WaMu's to alleviate its pressing capital requirements. After the
26 close of the market on April 7, additional reports circulated that WaMu was exiting its wholesale
27 lending business.

1 137. On April 8, 2008, the Company announced its first quarter 2008 results, including
2 a net loss of \$1.1 billion. The quarterly dividend was reduced from \$0.15 to \$0.01. The
3 Company also disclosed that the loan loss provision increased to \$3.5 billion, almost double what
4 the Company stated it would be on December 10, 2007. The Company also stated that it was
5 closing all 186 of its stand-alone home loan offices nationwide and eliminating approximately
6 3,000 jobs as part of the closings. The Company also announced that it would raise \$7 billion in
7 capital through a direct sale of equity securities to an investment vehicle managed by TPG
8 Capital.

9 138. On April 11, 2008, Goldman Sachs issued a report, recommending that
10 its clients short-sell WaMu stock because it estimated that WaMu has “\$17 to \$23 billion of
11 embedded losses in its current book of business” and forecasted “a “\$14b provision charge in
12 2008.” Goldman Sachs further estimated that WaMu may lose \$3.30 per share in 2008.

13 139. On April 16, 2008, Chris Brendler of Stifel Nicolaus issued a report and
14 questioned the Company’s ability to return to profitability, observing, “as [management]
15 struggles to right the sinking ship, we are increasingly questioning the value of [WaMu]’s
16 remaining franchise. The home loan business is broken, the loan portfolio is a disaster. . . .”

17 140. On April 29, 2008, WaMu announced that Defendant Cathcart had left the
18 Company.

19 141. On May 12, 2008, WaMu the filed with the SEC its Form 10-Q for the quarter
20 ended March 31, 2008 (the “First Quarter 2008 Form 10-Q”), which was signed by Defendants
21 and Casey and included certifications by Defendants Killinger and Casey. The First
22 Quarter 2008 Form 10-Q repeated the financial results set forth in the Company’s April 8, 2008
23 press release. The First Quarter 2008 Form 10-Q continued to conceal the Company’s improper
24 lending and, accounting practices and deficient risk management as well as the true extent of the
25 Company’s loss exposure.

26 142. On June 2, 2008, WaMu announced that, effective July 1, 2008, the Company was
27 stripping Defendant Killinger of his title of Chairman of the Board, and that Director Defendant
28 Stephen Frank would replace him in the position of Chairman.

1 143. On June 9, 2008, UBS Investment Research published a detailed analyst report on
2 WaMu, concluding, that cumulative losses on WaMu's mortgage portfolio will likely total close
3 to \$21.7 billion through 2011, between 12.5 to 44% greater than the loss guidance of \$12 to \$19
4 billion that the Company provided to the market in April 2008. Moreover, with respect to its
5 \$21.7 billion loss estimate, UBS observed that it might still be too low, stating: "The attributes of
6 WM's remaining loan portfolio and broader economic weakening mean our bias is that losses
7 could be worse than our projection." This report also estimated that WaMu would record \$24.2-
8 \$24.7 billion in incremental loan loss provisions between now and 2010.

9 144. After the close of the market on July 14, 2008, WaMu issued a press release,
10 claiming that the Company's was sufficiently capitalized and had excess liquidity of more than
11 \$40 billion. As a result of this press release, the market price of WaMu's stock rebounded
12 slightly, rising to \$5.92 per share in the days following this announcement.

13 145. Yet, just ten days later, after the markets closed on July 22, 2008, WaMu
14 announced its second quarter 2008 financial results, revealing that the Company suffered a net
15 loss of \$3.3 billion, more than 65% greater than the Company's first quarter 2008 net loss of
16 \$1.14 billion, driven by a significant increase in its loan loss reserves. The Company further
17 announced that it increased its loan loss reserves by \$3.74 billion to \$8.46 billion and that it took
18 a \$5.9 billion loan loss provision in the quarter, an increase of 40% from the \$3.5 billion
19 provision that the Company recorded in the first quarter 2008. The Company explained:
20 "approximately one third of the second quarter provision for loan losses related to significant
21 changes in key assumptions the company used to estimate incurred losses in its loan portfolio."
22 Specifically, the Company shortened the time period used to evaluate defaults for its prime
23 mortgage portfolio to one year from three years "to reflect the evolving risk profile of the loan
24 portfolio and adjusted its severity assumptions for all single family mortgages to reflect the
25 continuing decline in home prices." In addition, WaMu announced that its unpaid mortgages,
26 foreclosed homes and other nonperforming assets continued to increase during the second
27 quarter.

1 146. That same day, WaMu held a conference call to discuss the Company's second
2 quarter 2008 financial results. During the call, Killinger and Casey reviewed the results set forth
3 in the Company's press release. They also explained that, in 2008, the Company's Option ARM
4 loans experienced the fastest rise in delinquency rates and that they expected "other prime loans,
5 which are mostly 5 and 7 year hybrids, to follow Option ARMs closely." According to John
6 McMurray, WaMu's new Chief Enterprise Risk Officer, home equity loans and subprime
7 mortgages had experienced high delinquency rates during the late 2006 to late 2007 time period.

8 147. The market reacted swiftly to this news, driving down the stock price 20% from a
9 closing price of \$5.82 per share on July 22, 2008 to a closing price of \$4.65 per share on July 23,
10 2008. Dominion Bond Rating Service Limited and Standard & Poor's downgraded
11 WaMu's bond ratings. Moody's placed WaMu and its bank subsidiary on review for a
12 downgrade to junk status. Piper Jaffray downgraded WaMu to "Sell" and Merrill Lynch cut the
13 Company's rating to "Underperform."

14 148. On September 15, 2008, WaMu received another credit rating agency downgrade.
15 From that date through September 24, 2008, customers withdrew \$16.7 billion in deposits.

16 149. On September 25, 2008, the OTS seized Washington Mutual Bank from WaMu
17 and placed it into the receivership of the Federal Deposit Insurance Corporation (FDIC). The
18 FDIC sold the banking subsidiaries (minus unsecured debt or equity claims) to JPMorgan Chase
19 for \$1.9 billion, which reopened the bank the next day.

20 150. On September 26, 2008, WaMu filed for bankruptcy. Washington Mutual Bank's
21 closure and receivership is the largest bank failure in American financial history. Before the
22 receivership action, it was the sixth-largest bank in the United States. According to WaMu 2007
23 Annual Report, the holding company held assets valued at \$327.9 billion.

24 151. Monterey County, and the millions of residents it includes, have been left in the
25 disastrous wake of Defendants' conduct and the County's note is in default.

1 **F. The Central Role Of Deloitte**

2 152. Deloitte served as WaMu’s outside auditor for years, including throughout the
3 relevant period. WaMu retained Deloitte to conduct quarterly reviews of its interim financial
4 results and to conduct the annual audit of the Company’s fiscal results, including for fiscal years
5 ending in 2005 and 2006. As the “independent” auditor, Deloitte was responsible for conducting
6 audits on WaMu’s financial statements and issuing audit reports, knowing that they would be
7 used and relied upon by prospective and existing investors of WaMu, as well as analysts, in
8 evaluating the purchase and holding of WaMu securities. Indeed, the reports were specifically
9 addressed to WaMu’s stockholders. Thus, the County was an intended beneficiary of Deloitte’s
10 audit reports.

11 153. By virtue of its long history with WaMu, Deloitte was intimately familiar with
12 WaMu’s business model, its employees, its products, and its increasing exposure by virtue of its
13 loan practices. Moreover, in the course of its work, including its audit planning procedures for
14 the audits, Deloitte reviewed WaMu’s internal controls, paying specific attention to loan
15 practices, real estate loan valuations and risk exposure. Deloitte audited large transactions and
16 received from WaMu numerous materials concerning those transactions. Deloitte participated in
17 drafting and reviewing WaMu’s quarterly press releases, which announced WaMu’s
18 performance, financial condition, asset valuations and revenues. Deloitte reviewed drafts of
19 WaMu’s filings with the SEC prior to filing. Deloitte also attended and made presentations at
20 Board of Director and Committee meetings, where it discussed the results of its examination of
21 WaMu’s financial statements.

22 154. With respect to its audit work, Deloitte provided “clean” audit opinions included
23 in WaMu’s Form 10-K for 2005, 2006 and 2007, confirming that Deloitte had conducted its audit
24 in accordance with GAAS and that based on its review, WaMu’s financial statements fairly
25 presented the Company’s financial position for fiscal years 2005, 2006 and 2007, in accordance
26 with GAAP.

1 155. As noted above, these clean audit reports were critical to WaMu's ability to
2 continue raising money from its debt offerings investments. Deloitte had unique access to the
3 underlying information used to prepare the Company's financial statements, which was not
4 available to the public, and was well aware that WaMu was differentiating itself from its
5 competitors.

6 156. Deloitte was also well aware that investors, like the County, were relying on it to
7 investigate and confirm that WaMu's financial condition was accurately reported. Deloitte
8 promoted itself as one of the foremost accounting firms in the world, with special experience in
9 real estate and sophistication in accounting for complex capital markets. Deloitte also promoted
10 its multi-disciplinary business to address the particular risks for audit clients engaged in real
11 estate, combining the skills of audit, tax, advisory and valuation professionals.

12 157. Similarly, Deloitte recognized that prospective and existing investors in WaMu,
13 like the City, were the intended beneficiaries of its work.

14 158. Deloitte's knew that the entire point of an audit is to protect the Company's
15 *investors*, who do not have access to inside information. This is consistent with the United
16 States Supreme Court's pronouncement relating to the special "public watchdog" role of an
17 accountant in assuring the accuracy of financial statement:

18 By certifying the public reports that collectively depict a corporation's financial status,
19 the independent auditor assumes a ***public responsibility transcending any employment***
20 ***relationship with the client***. The independent public accountant performing this special
21 function owes ***ultimate allegiance to the corporation's creditors and stockholders, as***
22 ***well as the investing public***. This ***"public watchdog" function demands that the***
23 ***accountant maintain total independence from the client at all times and requires***
24 ***complete fidelity to the public trust***. To insulate from disclosure a certified public
25 accountant's interpretations of the client's financial statements would be to ignore the
26 significance of the accountant's role as a disinterested analyst charges with public
27 obligations.

28 *U.S. v. Arthur Young & Co.* (1984) 465 U.S. 805, 817-18 (emphasis added); *accord Bily v.*
Arthur Young & Co. (1992) 3 Cal.4th 370, 383-84; *National Medical Transp. Network v.*
Deloitte & Touche (1998) 62 Cal.App.4th 412, 428-29.

1 159. Deloitte was also well aware of the particular audit risks at WaMu, given the
2 bank's extensive real estate-related assets and reliance on loan revenues. A basic principle of
3 financial accounting standards requires not only accurate financial statements, but also the
4 recording of loan losses. Thus, Deloitte recognized the risk of nonpayment, especially of
5 subprime loans. Deloitte also recognized the audit risk created by WaMu's exposure to even a
6 minor downturn in the market, and the fact that others in the market had decided to take
7 recognize large losses on similar assets.

8 160. In addition, Deloitte recognized that WaMu's management had a built-in
9 incentive to inflate WaMu's financial condition and the value of its assets, given the Company's
10 compensation structure. Indeed, the Officer Defendants stood to receive bonuses and other
11 rewards under the Company's compensation plans, directly tied to short-term benchmarks.

12 161. However, contrary to its public statements and its professional duties to WaMu's
13 investors, Deloitte failed to design or perform its audit in a manner to account for these audit
14 risks, and therefore was unable to provide unqualified opinions regarding WaMu's financial
15 statements.

16 162. The entire purpose of an audit is to obtain an opinion that the financial statements
17 fairly present, in all material respects, the financial position of the company in conformity with
18 accounting principles generally accepted in the United States ("GAAP"). These principles are
19 further clarified by Statements on Auditing Standards ("SAS") that are referred to with an "AU"
20 number. The auditor has the affirmative duty to plan and perform the audit to obtain **reasonable**
21 **assurance** that the financial statements are free of material misstatement, whether caused by
22 error or fraud. AU 110.02.

23 163. To obtain such reasonable assurance, the independent auditor has to perform
24 specific procedures called for by GAAS and, after performing such procedures, determine if
25 anything came to his or her attention that would lead them to believe that the financial statements
26 were not fairly presented in accordance with GAAP. AU 722.09. Indeed, the audit process
27 **requires professional skepticism** in order to properly test management's representations so that
28 the auditor actually has a reasonable basis on which to form an opinion regarding the financial

1 statements. AU 333.02. The audit opinion is valuable precisely because the auditor is
2 supposedly conducting an *independent* and *skeptical* examination of the information provided by
3 management.

4 164. Thus, the auditor must consider both audit risk and materiality in (1) planning the
5 audit and designing audit procedures, and (2) in evaluating the results of the audit in relation to
6 the financial statements as a whole. AU 312.12. The auditor must plan the audit to obtain
7 reasonable assurance of detecting material misstatements that it believes could be large enough,
8 individually or in the aggregate, to be quantitatively material to the financial statements. AU
9 312.20.

10 165. Deloitte failed to adhere to these basic accounting principles. As a result, its audit
11 reports misrepresented the true financial condition of WaMu and misrepresented that it had
12 conducted its audits in compliance with professional standards of care. In performing its audit
13 work for WaMu, Deloitte agreed and had a duty to perform such work in conformity with GAAP,
14 as well as the standard of care established by the American Institute of Certified Public
15 Accountant (“AICPA”), including the GAAS’ Ten (10) Professional Standards of Care:

16 ***General Standards***

- 17 1. The audit must be performed by a person or persons having adequate technical training
18 and proficiency as an auditor.
19 2. In all matters relating to the assignment, an independence in mental attitude is to be
20 maintained by the auditor or auditors.
21 3. Due professional care is to be exercised in the planning and performance of the audit
22 and the preparation of the report.

23 ***Standards of Field Work***

- 24 4. The work is to be adequately planned and assistants, if any, are to be properly
25 supervised.
26 5. A sufficient understanding of internal controls is to be obtained to plan the audit and to
27 determine the nature, timing, and extent of tests to be performed.
28 6. Sufficient competent evidential matter is to be obtained through inspection,
observation, inquiries, and confirmations to afford a reasonable basis for an opinion
regarding the financial statements under audit.

1 ***Standards of Reporting***

2 7. The report shall state whether the financial statements are presented in accordance with
3 Generally Accepted Accounting Principles.

4 8. The report shall identify those circumstances in which such principles have not been
5 consistently observed in the current period in relation to the preceding period.

6 9. Informative disclosures in the financial statements are to be regarded as reasonably
7 adequate unless otherwise stated in the report.

8 10. The report shall either contain an expression of opinion regarding the financial
9 statements, taken as a whole, or an assertion to the effect that an opinion cannot be
10 expressed. When an overall opinion cannot be expressed, the reasons therefor should be
11 stated. In all cases where an auditor's name is associated with financial statements, the
12 report should contain a clear-cut indication of the character of the auditor's work, if any,
13 and the degree of responsibility the auditor is taking.

14 166. Based upon its annual audit and quarterly reviews, Deloitte knew or recklessly
15 disregarded the true financial condition and exposure of WaMu, the value of WaMu' loan
16 "assets," the true credit risks, and WaMu's deteriorating financial condition, which contradicted
17 the unqualified audit reports on WaMu's financial statements meant to be distributed to the
18 market. Deloitte's reports used by WaMu to promote its securities to the market were issued in
19 clear violation of professional standards and fiduciary duties.

20 167. Based upon its annual audit and quarterly reviews, Deloitte also knew or should
21 have known about the inadequate internal control structure. Indeed, Deloitte discussed with
22 WaMu's management, including the Board and Committees, responsibility for establishing and
23 maintaining adequate internal controls for WaMu and for ensuring that the Company's financial
24 statements were based on accurate financial information, including that WaMu:

- 25 (a) make and keep books, records, and accounts, which, in reasonable detail,
26 accurately and fairly reflect the transactions and dispositions of the assets
27 of the issuer; and
- 28 (b) devise and maintain a system of internal accounting controls sufficient to
 provide reasonable assurances that –
- (i) transactions are executed in accordance with management's general
 or specific authorization;
- (ii) transactions are recorded as necessary to permit preparation of
 financial statements in conformity with GAAP.

1 Nonetheless, Deloitte certified WaMu's financial statements, knowing that WaMu's internal
2 controls were inadequate.

3 168. The misstatements of WaMu's quarterly and annual financial statements were
4 material and in violation of GAAP. Deloitte breached its professional responsibilities and acted
5 in violation of GAAP and GAAS in its review of the above-specified quarterly financials and
6 audits of the annual financial statements of WaMu.

7 169. Deloitte violated GAAS General Standard No. 3, which requires the auditor to
8 exercise due professional care in the performance of the audit and preparation of the audit report.

9 170. Deloitte violated GAAS Reporting Standard No. 1, which requires the audit report
10 to state whether the financial statements are presented in accordance with GAAP. Deloitte's
11 audit opinion falsely represented that WaMu's financial statements complied with GAAP. For
12 example, WaMu and the other Defendants failed to comply with FAS 157, which required that
13 financial instruments and other inventory positions must be reported at fair value.

14 171. Deloitte violated GAAS Field Standard No. 1, and the standards set forth in AU
15 sections 310, 320, 327, and others, by failing to adequately plan its audit and properly supervise
16 the work of assistants so as to establish and carry out procedures reasonably designed to search
17 for and detect the existence of errors and irregularities which would have a material effect upon
18 the financial statements.

19 172. Deloitte violated AU section 316, which requires the auditor to plan and perform
20 its examination of the financial statements with professional skepticism. Section 316 begins with
21 the statement that: "the auditor has a responsibility to plan and perform the audit to obtain
22 reasonable assurance about whether the financial statements are free of material misstatement,
23 whether caused by error or fraud." AU §316.01. In WaMu's case, there were numerous audit red
24 flags and risk factors that alerted Deloitte to the potential of misstatements.

25 173. Deloitte failed to expand its audit procedures and perform effective audit testing
26 to obtain more reliable, persuasive audit evidence because of the above-described significant risk
27 factors and audit red flags. As section 316 states, "[t]he nature of audit procedures may need to
28 be changed to obtain evidence that is more reliable or to obtain additional corroborative

1 information. For example, more evidential matter may be needed from independent sources
2 outside the entity.” Deloitte failed to obtain adequate confirmations and/or otherwise
3 communicate directly with affiliates of WaMu regarding the true value and exposure from
4 WaMu’s loan practices and failed to fully understand the relationships between the parties,
5 despite knowledge of risk factors and audit red flags that required action on Deloitte’s part.
6 Section 316.27, which discusses the need to exercise professional skepticism in response to the
7 risk of material misstatement, directs: (a) increased sensitivity in the selection of the nature and
8 extent of documentation to be examined in support of material transactions, and (b) increased
9 recognition of the need to corroborate management explanations or representations concerning
10 materials matters.

11 174. Deloitte violated AU section 722, which requires the auditor to ensure that the
12 Audit Committee of the Board of Directors is aware of, and responds appropriately to, any
13 irregularities that the auditor discovers as part of a review of interim financial information to be
14 filed with a regulatory agency, such as the SEC.

15 175. Deloitte violated AU section 722.18, which states: “If, in performing a review of
16 interim financial information, the accountant becomes aware of information that leads him or her
17 to question whether the interim financial information to be reported conforms with generally
18 accepted accounting principles, the accountant should make additional inquiries or employ other
19 procedures he or she considers appropriate to provide the limited assurance for a review
20 engagement.” In view of all the previously described risk factors and audit red flags at WaMu,
21 Deloitte should have made additional inquiries, including further communications with
22 customers and other related parties, as described above.

23 176. By giving of the unqualified audit opinions for the WaMu financial statements
24 for fiscal years 2005, 2006 and 2007, Deloitte certified that its audits of WaMu’s books and
25 records were done in accordance with GAAP and GAAS. They were not. Thus, Deloitte’s
26 statements were materially misleading.

1 **V. CAUSES OF ACTION**

2 **FIRST CAUSE OF ACTION**

3 **(Fraud and Deceit)**

4 177. Plaintiff incorporates and realleges each of the foregoing paragraphs, as though
5 fully set forth herein and further alleges as follows.

6 178. Defendants, and each of them, made material representations and omissions to
7 Plaintiff which were false and misleading, including those contained in press releases, public
8 statements, financial statements, SEC filings, registration statements, and other disclosures made
9 by Defendants, described above.

10 179. As described above, Defendants understated the Company's Allowance by
11 millions of dollars in each quarter, which had a dollar-for-dollar impact on the Company's
12 reported pre-tax income. The effect on net income would be reduced by the Company's effective
13 tax rate. As a result of Defendants' manipulation of the Company's Allowance, WaMu reported
14 artificially inflated net income. WaMu should have increased its reserves during the to take into
15 account the lower credit quality of its home loan portfolio. Defendants also concealed the
16 inadequacy of WaMu's internal controls by falsely representing to investors that the Company's
17 internal controls over financial reporting were effective. Defendants Killinger and Casey each
18 repeatedly and falsely certified the design, operation and effectiveness of WaMu's internal
19 controls in the Company's annual and quarterly financial statements. However, the Company's
20 purported control environment failed to ensure that the financial statements issued were reliable
21 or in compliance with applicable laws. Rather, Defendants focused on increasing loan volume
22 origination without regard to the quality of such loans in an effort to reach aggressive market
23 share goals without taking the steps required under GAAP and SEC guidelines to account
24 properly for their activities. In addition, Deloitte issued unqualified audit reports on WaMu's
25 financial statements, which they knew and intended would be read and relied upon by
26 prospective and existing investors in WaMu notes and securities, like the County, and which
27 were in fact read and relied upon by the County in making its investment decisions.

1 180. When Defendants, and each of them, made the representations and failed to
2 disclose and suppressed information they had a duty to disclose, as set forth hereinbefore,
3 Defendants had knowledge of the falsity of their statements and representations and knew that
4 they were failing to disclose material facts which they had a duty to disclose.

5 181. Defendants made the misrepresentations and omitted the material facts with the
6 intent to defraud Plaintiff and to induce Plaintiff to purchase and hold the WaMu note.

7 182. At the time these misrepresentations were made and the material facts not
8 disclosed, and at the time that Plaintiff took the actions herein alleged, Plaintiff was ignorant of
9 the true facts. If Plaintiff had known the true facts, it would not have invested in or continued to
10 hold the WaMu note, and would have divested of it immediately.

11 183. Plaintiff reasonably relied on these representations, including Deloitte's
12 unqualified audit reports, in investing in and continuing to hold WaMu securities and its reliance
13 was justified since the Defendants had exclusive knowledge of the true facts.

14 184. Defendants knew that a fraud was occurring in the representations about WaMu.
15 Notwithstanding their knowledge of this improper and unlawful conduct, these Defendants, and
16 each of them, engaged in conduct, hereinbefore described which rendered substantial assistance
17 to, encouraged and/or aided and abetted the fraud.

18 185. With knowledge of the unlawful purpose of the fraud, Defendants, and each of
19 them, entered into an agreement to accomplish the aforesaid scheme, and by their actions took
20 steps to further that scheme.

21 186. As a direct and proximate result of the wrongful conduct of each of the
22 Defendants, Plaintiff has suffered and will continue to suffer economic losses and other general
23 and specific damages, all in an amount to be determined according to proof.

24 187. The aforementioned acts of Defendants, and each of them, were done
25 maliciously, oppressively, and with intent to defraud, and Plaintiff is entitled to punitive and
26 exemplary damages in an amount to be shown according to proof at the time of trial.

27

28

1 **SECOND CAUSE OF ACTION**

2 **(Negligent Misrepresentation)**

3 188. Plaintiff incorporates and realleges each of the foregoing paragraphs, as though
4 fully set forth herein and further alleges as follows.

5 189. Defendants, and each of them, negligently made material representations to
6 Plaintiff which were false and misleading, including those contained in press releases, public
7 statements, SEC filings, financial statements, registration statements, and other disclosures made
8 by Defendants, described above.

9 190. As described above, Defendants understated the Company's Allowance by
10 millions of dollars in each quarter, which had a dollar-for-dollar impact on the Company's
11 reported pre-tax income. The effect on net income would be reduced by the Company's effective
12 tax rate. As a result of Defendants' manipulation of the Company's Allowance, WaMu reported
13 artificially inflated net income. WaMu should have increased its reserves during the to take into
14 account the lower credit quality of its home loan portfolio. Defendants also misrepresented the
15 adequacy of WaMu's internal controls by falsely representing to investors that the Company's
16 internal controls over financial reporting were effective. Defendants Killinger and Casey each
17 repeatedly and falsely certified the design, operation and effectiveness of WaMu's internal
18 controls in the Company's annual and quarterly financial statements. However, the Company's
19 purported control environment failed to ensure that the financial statements issued were reliable
20 or in compliance with applicable laws. Rather, Defendants focused on increasing loan volume
21 origination without regard to the quality of such loans in an effort to reach aggressive market
22 share goals without taking the steps required under GAAP and SEC guidelines to account
23 properly for their activities. In addition, Deloitte issued unqualified audit reports on WaMu's
24 financial statements, which it knew and intended would be read and relied upon by prospective
25 and existing investors in WaMu notes and securities, like the County, and which were in fact
26 read and relied upon by the County in making its investment decisions.

1 Plaintiff as they sought to induce, and did induce Plaintiff to purchase and hold the note,
2 knowing of the County's particular circumstances.

3 199. The Individual Defendants and each of them, had insider knowledge of adverse
4 non-public information regarding the securities as alleged above. The Individual Defendants
5 knowingly and intentionally concealed this adverse non-public information from the Plaintiff.

6 200. The Individual Defendants, and each of them, breached and violated their
7 fiduciary obligations to Plaintiff, to the detriment of Plaintiff, by failing to disclose all material
8 information known to them at the time that Plaintiff purchased and held the note, and by making
9 the above-mentioned misrepresentations to induce Plaintiff to purchase and hold the note or to
10 take other actions.

11 201. As set forth above, the Defendants knew that WaMu was engaged in fraudulent
12 conduct, and that the Individual Defendants, and each of them, were breaching their fiduciary
13 duties to WaMu's note holders and investors. Notwithstanding their knowledge of the improper
14 and unlawful conduct, the Defendants, and each of them, engaged in conduct, hereinbefore
15 described which rendered substantial assistance to, encouraged and/or aided and abetted the
16 breach of fiduciary duty.

17 202. With knowledge of the unlawful purpose of the conduct of WaMu, and the other
18 Defendants, the Defendants, and each of them, entered into an agreement to accomplish the
19 aforesaid scheme, and by their actions took steps to further that scheme.

20 203. As a result of the wrongful conduct of each of the Defendants, Plaintiff has
21 suffered and will continue to suffer economic losses and other general and specific damages, all
22 in an amount to be determined according to proof.

23 204. The aforementioned acts of Defendants, and each of them, were done maliciously,
24 oppressively, and with intent to defraud, and Plaintiff is entitled to punitive and exemplary
25 damages in an amount to be shown according to proof at the time of trial.

26 WHEREFORE, Plaintiff prays for relief as set forth below.
27

1 **FOURTH CAUSE OF ACTION**

2 **(Violation of California Corporations Code § 25400 *et seq.*)**

3 205. Plaintiff hereby realleges and incorporates by reference each of the foregoing
4 paragraphs as though fully set forth herein and further alleges as follows.

5 206. Defendants, and each of them, acting individually and pursuant to a
6 scheme and conspiracy, directly and indirectly to, induce the purchase and retention of the note
7 by the Plaintiff by circulating or disseminating, in or from California, information that falsely
8 described WaMu's financial condition and exposure, as described above, for the purpose of
9 inducing Plaintiff to purchase and hold the note. Defendants knew or had reason to believe that
10 their statements were false or misleading in light of the circumstances under which they were
11 made. As a result of the misrepresentations, Defendants knew that investors like Plaintiff would
12 be misled and would purchase and hold WaMu notes based upon false information. Despite this
13 knowledge, Defendants continued to make the misrepresentations in order to induce investors to
14 purchase and hold such notes.

15 207. Defendants, and each of them, also knowingly provided substantial assistance to
16 the other Defendants in violation of the Corporations Code Section 25403.

17 208. Defendants, and each of them are liable for wilfully participating in acts or
18 transactions in violation of Corporations Code Sections 25400 and 25403, and thus are liable to
19 Plaintiff, which purchased its interest in the WaMu note at a price which was affected by
20 Defendants' acts, for damages sustained by Plaintiff as a result of such acts or transactions.

21 209. As a direct and proximate result of the wrongful conduct of Defendants and each
22 of them, Plaintiff has sustained economic losses and other general and special damages,
23 including damages pursuant to Section 25500, in an amount to be determined according to proof
24 at the time of trial.

25 210. Plaintiff is entitled to an award of prejudgment interest at the legal rate on its
26 economic damages, pursuant to Section 25500.

27 WHEREFORE, Plaintiff prays for relief as set forth below.

1 **VI. PRAYER FOR RELIEF**


- 2 1. Compensatory and general damages according to proof;
- 3 2. Special damages according to proof;
- 4 3. Restitution according to proof;
- 5 4. Prejudgment interest at the maximum rate;
- 6 5. Punitive and exemplary damages according to proof;
- 7 6. Costs of the proceedings herein;
- 8 7. Reasonable attorneys fees; and
- 9 8. All such other and further relief as the Court deems just and proper.

10 **VII. DEMAND FOR JURY TRIAL**

11 Plaintiff demands a trial by jury.

12 Dated: March 6, 2009

COTCHETT, PITRE & McCARTHY

13
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