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17  
 18 UNITED STATES DISTRICT COURT  
 19 CENTRAL DISTRICT OF CALIFORNIA

20 In re COUNTRYWIDE FINANCIAL  
 21 CORP. DERIVATIVE LITIGATION

Case No. 07-CV-06923-MRP-(MANx)  
 (Lead)

22 **PLAINTIFFS' MEMORANDUM OF**  
**POINTS AND AUTHORITIES IN**  
 23 **OPPOSITION TO DEFENDANTS'**  
**MOTIONS TO DISMISS**

24 Judge: Hon. Mariana R. Pfaelzer  
 25 Ctrm: 12  
 26 Hearing: April 28, 2008  
 10:00 a.m.

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1           Lead Plaintiffs Arkansas Teacher Retirement System, Fire & Police Pension  
2 Association of Colorado, Louisiana Municipal Police Employees' Retirement  
3 System ("LAMPERS"), and Public Employees' Retirement System of Mississippi,  
4 and Plaintiff Central Laborers Pension Fund (collectively, "Plaintiffs"), on behalf  
5 of Nominal Defendant Countrywide Financial Corporation ("Countrywide" or the  
6 "Company"), respectfully submit this omnibus opposition to the motions to dismiss  
7 filed by the Individual Defendants (Dkt. No. 89), Defendant Michael E. Dougherty  
8 (Dkt. No. 86),<sup>1</sup> and Countrywide (Dkt. Nos. 78, 80, 92).

9           I.       INTRODUCTION AND SUMMARY OF ALLEGATIONS

10           This case centers on Defendants' extensive pattern of misconduct and  
11 complete abandonment of any regard for their fiduciary duties. As alleged in the  
12 Consolidated Shareholder Derivative and Class Action Complaint ("Complaint")  
13 and explained below, Defendants caused Countrywide to engage in increasingly  
14 risky lending practices and to abandon its underwriting standards so that they could  
15 publicly report inflated loan volume and financial results. Defendants caused  
16 Countrywide to understate its allowances for loan losses, overstate the value of its  
17 loan assets, and misstate the effectiveness of its hedging activities, which were  
18 purportedly designed to offset impairments to the Company's loan portfolios.

19           While Defendants created the false appearance that the Company was  
20 conservatively managed and poised for long-term success, Defendants  
21 simultaneously looted the Company through massive insider sales and oversized  
22 compensation for their own benefit. Indeed, Defendants sold over **\$848 million** of  
23 \_\_\_\_\_

24           <sup>1</sup> This opposition refers to the Individual Defendants (Angelo R. Mozilo, David J.  
25 Sambol, Jeffrey M. Cunningham, Robert J. Donato, Martin R. Melone, Robert T.  
26 Parry, Oscar P. Robertson, Keith P. Russell, Harley W. Snyder, Henry G. Cisneros,  
27 Stanford L. Kurland, Carlos M. Garcia, and Eric P. Sieracki) and Defendant  
28 Michael E. Dougherty collectively as "Defendants." This opposition specifically  
references Defendant Dougherty when responding to his arguments that were not  
also raised by the Individual Defendants. Defendant Bank of America ("BofA")  
has withdrawn its motion to dismiss (Dkt. No. 116) in light of the Court's recent  
order. (Dkt. No. 111).

1 Countrywide stock between 2004 and January 2, 2008 (the “Relevant Period”) –  
2 much of it when Defendants knew the Company was on the brink of an economic  
3 collapse resulting from their conduct. Moreover, as news about lenders’ exposure  
4 to risky loans began to surface in 2006, Defendants forced Countrywide to engage  
5 in a multi-billion dollar stock repurchase plan funded, in large part, with debt that  
6 Defendants caused Countrywide to incur. While forcing the Company to *buy* its  
7 own stock at inflated prices, Defendants stood on the other side of the transaction,  
8 *selling* \$133 million of Countrywide stock.

9 Defendants argue that the Complaint fails to sufficiently plead claims, upon  
10 which relief may be granted. The Complaint, however, more than adequately  
11 pleads violations of federal and state law. For example, Defendants violated §  
12 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) by making false  
13 and misleading statements concerning: (i) the Company’s underwriting policies  
14 and the quality of the Company’s loans; (ii) the Company’s financial results, which  
15 Defendants falsified by manipulating reported allowances for loan losses; (iii) the  
16 effectiveness of the Company’s hedging activities purportedly established to offset  
17 loan losses; and (iv) the Company’s creditworthiness. See § II.B.1. Each of the  
18 Defendants, including the Director Defendants who signed the Company’s annual  
19 reports with the Securities and Exchange Commission (“SEC”), is liable for  
20 making these materially false and misleading statements. Further, the Complaint  
21 pleads a strong inference of Defendants’ scienter, which is established by, among  
22 other factors: (i) massive and suspiciously timed sales of Company stock;  
23 (ii) contemporaneous knowledge of information contradicting Defendants’ public  
24 statements; (iii) repeated violations of accounting rules and Company policies; and  
25 (iv) the fact that Countrywide’s fraudulent lending practices and accounting  
26 manipulations were of such a critical nature to Countrywide’s business that they  
27 constituted the Company’s core business activities and could have only been  
28

1 ignored by Defendants purposefully turning a blind eye to improper conduct they  
2 were obligated to monitor. See § II.B.2. These allegations are well-supported by  
3 various independent sources – including numerous former Countrywide employees  
4 – and as such must be accepted as true for the purposes of the motions to dismiss.  
5 These allegations also form the basis of the Complaint’s well-pleaded claims for  
6 Defendants’ violations of §§ 14(a), 20(a), and 20A of the Exchange Act, as well as  
7 state law claims under Delaware and California state law. See §§ II.C through II.F.

8 Finally, as explained below, the Complaint alleges a reasonable doubt that,  
9 at the time it was filed, a majority of the Board could not have properly exercised  
10 independent and disinterested judgment in responding to the allegations and  
11 demand would have been futile. For all of the above reasons, the Court should  
12 deny the motions to dismiss.

## 13 II. ARGUMENT

### 14 A. The Complaint Sufficiently Alleges Demand Futility

15 Defendants contend that the Complaint fails to allege that demand on  
16 Countrywide’s Board is excused as futile. Countrywide argues that, even  
17 assuming the truth of all the allegations in the Complaint, the Board would still be  
18 “the best judge of whether litigation should be pursued on behalf of the  
19 corporation.” CFC Mem. at 1.<sup>2</sup> This argument is unsupported by Delaware law  
20 given the particularized allegations in the Complaint demonstrating that a majority  
21 of the Countywide Board: (1) has overwhelming self-interests at stake in the  
22 outcome of the litigation; and (2) faces a substantial likelihood of liability.

#### 23 1. The Applicable Legal Standards

24 Shareholders seeking to vindicate the interests of a corporation through a  
25 derivative suit must allege either that they have made a demand on the board of  
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27 <sup>2</sup> Defendants’ memoranda of law in support of their motions to dismiss are herein  
28 cited as, *e.g.*, “CFC Mem.” (for Countrywide’s memorandum of law).

1 directors, or the reasons why such a demand would have been futile.<sup>3</sup> To excuse  
2 demand, a plaintiff need not plead evidence, nor prove success on the merits.<sup>4</sup>  
3 Rather, in determining demand futility, courts must accept all particularized  
4 allegations as true and draw all reasonable inferences in plaintiffs' favor that  
5 logically flow from such allegations.<sup>5</sup> Further, where a complaint  
6 advances numerous reasons supporting demand futility, a court must consider the  
7 totality of these circumstances to assess whether a reasonable doubt is raised  
8 regarding directors' disinterest or independence.<sup>6</sup>

9 Delaware law employs two tests in determining whether demand is excused.  
10 When the alleged wrong constitutes a business decision by the board of directors,  
11 courts employ the test set forth in *Aronson*, which evaluates whether, under the  
12 facts alleged, a reasonable doubt is created that either: (1) the directors are  
13 disinterested or independent; *or* (2) the challenged transaction was otherwise the  
14 product of a valid exercise of business judgment. 473 A.2d at 814. There are two  
15 kinds of allegations from which a court may infer a reasonable doubt regarding the  
16 disinterestedness of a director. First, “[d]irector interest exists whenever divided  
17 loyalties are present, or a director either has received, or is entitled to receive, a  
18 personal financial benefit from the challenged transaction which is not equally  
19 shared by the stockholders.” *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984). A  
20 classic example is when directors “appear on both sides of a transaction.”  
21 *Aronson*, 473 A.2d at 812. Second, reasonable doubt regarding a director’s  
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23 <sup>3</sup> See Fed. R. Civ. P. 23.1; *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), overruled  
24 on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

25 <sup>4</sup> See *Levine v. Smith*, 591 A.2d 194, 207 (Del. 1991); *Rales v. Blasband*, 634 A.2d  
26 927, 934 (Del. 1993).

27 <sup>5</sup> *Rales*, 634 A.2d at 931; *In re Nat’l Auto Credit, Inc. S’holders Litig.*, 2003 WL  
28 139768, at \*8 (Del. Ch. Jan. 10, 2003) (citations omitted); *Feldman v. Cutaita*,  
2006 WL 920420, at \*5 (Del. Ch. Apr. 5, 2006); *McCall v. Scott*, 239 F.3d 808,  
816-17, 824 (6th Cir. 2001).

<sup>6</sup> *Cal. Pub. Employees Ret. Sys. v. Coulter*, 2002 WL 31888343, at \*6 (Del. Ch.  
Dec. 18, 2002); *Harris v. Carter*, 582 A.2d 222, 229 (Del. Ch. 1990).

1 disinterestedness is raised where the allegations demonstrate that a director faces a  
2 “substantial likelihood” of liability. *Seminaris v. Landa*, 662 A.2d 1350, 1354  
3 (Del. Ch. 1995).

4 When the challenged act does not constitute a business decision by the  
5 board, however, courts employ the test set forth in *Rales*, 634 A.2d at 934. Under  
6 *Rales*, courts evaluate whether the allegations create “a reasonable doubt that, as of  
7 the time the complaint is filed, the board of directors could have properly exercised  
8 its independent and disinterested business judgment in responding to a demand.”  
9 634 A.2d at 934.

10 Applying these legal standards to the particularized allegations in the  
11 Complaint, the Plaintiffs have demonstrated that demand is excused as futile under  
12 *Aronson* and/or *Rales*.<sup>7</sup>

## 13 2. The Director Defendants

14 The parties agree that Countrywide’s Board consisted of the following nine  
15 members when the initial complaint was filed on October 24, 2007<sup>8</sup>:  
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24 <sup>7</sup> “¶” and “¶¶” refer to specific paragraphs in the Complaint. While Plaintiffs  
25 have summarized demand futility allegations in a separate section of the  
26 Complaint, *see* ¶¶394-474, many of the details supporting these summarized  
27 allegations are contained throughout the body of the Complaint.

28 <sup>8</sup> *See* CFC Mem. at 5. The amounts and dates for the insider sales are as alleged in  
the Complaint.

Non-Employee Directors	Audit & Ethics	Comp	Corp Gov & Nom	Credit	Fin	Oper & Pub Pol	Insider Sales during Repurchase Quarters (4Q'06 & 2Q'07)	Insider Sales during Relevant Period 2004 – October 2007
<b>Angelo R. Mozilo (Co-founder, Chairman, CEO)</b>							\$118,561,538	\$474,491,038
<b>David Sambol (President and COO)</b>							\$9,039,085	\$69,878,744
<b>Cunningham</b>							\$389,800	\$3,006,700
<b>Donato</b>							\$2,142,068	\$4,345,868
<b>Melone</b>								
<b>Parry</b>								
<b>Robertson</b>							\$2,388,000	\$10,215,668
<b>Russell</b>								\$371,243
<b>Snyder</b>							\$818,040	\$7,960,864
<b>TOTAL</b>							<b>\$133,338,531</b>	<b>\$570,270,125</b>
Committee Member  Committee Chair								

Countrywide's Chairman and Chief Executive Officer Mozilo and President and Chief Operating Officer Sambol are inside directors, and they are admittedly "interested" and "not independent" for purposes of demand futility analysis. Thus, Plaintiffs need only raise a reasonable doubt as to the interestedness of three additional directors.

As members of the Board of Directors Committee, the remaining Director Defendants had specific oversight responsibilities for various aspects of Countrywide's operations, and each Committee was tasked with reporting back to the complete Board. ¶¶75-97. Among other duties, the Audit and Ethics Committee (Melone – Chair, Parry, Russell) was charged with overseeing: (1) the integrity of the financial statements and the reporting processes; (2) the Company's internal audits; and (3) the Company's Code of Business Ethics. ¶79. The Audit and Ethics Committee's charter indicates that it would have had access to non-

1 public information on the Company's major financial risk exposure (and risk  
2 management policies); significant reports prepared by the internal auditing  
3 department and management's responses; the scope of the internal audit program;  
4 and the Company's risk assessment methodology. ¶80. The Audit and Ethics  
5 Committee met fourteen times in 2006. ¶81.

6 The Credit Committee (Russell – Chair, Donato, Parry) was charged with  
7 monitoring credit objectives, policies, controls, procedures and activities of the  
8 Company, including review of the Company's credit exposure, credit limits,  
9 allowances for loan losses and methodology, and loss mitigation. ¶87. The Credit  
10 Committee would have had access to non-public information regarding: credit risk  
11 management activities (including strategies, policies, controls, systems and  
12 methodologies of the Company); the methodology of credit loss reserves and  
13 adequacy of credit reserve levels employed by the Company; actual and projected  
14 credit losses; and activities and performance of the Company's credit committees.  
15 ¶88. The Credit Committee met five times in 2006. ¶89.

16 The Finance Committee (Donato – Chair, Melone, Robertson, Russell) was  
17 responsible for overseeing the financial objectives, policies, procedures and  
18 activities of the Company, including the review of the Company's capital structure,  
19 source of funds, liquidity and financial position. ¶91. Members of the Finance  
20 Committee would have had access to a host of non-public materials and  
21 information regarding, among other things: the capital structure, liquidity, and  
22 capital adequacy and reserves; long-term financing strategy and plans; policies  
23 relating to liquidity management and capital structure; capital budgets and  
24 financial plans; market risk policies, including those related to interest rate risk;  
25 investment strategies and policies, and investments and assets held, including  
26 mortgage servicing rights and other retained interests; and information on  
27 mortgage sales and securitizations, and the secondary marketing objectives,  
28

1 strategies, policies, procedures and controls. ¶92. In addition, the Committee  
2 members were able to review management's recommendations with respect to  
3 equity repurchases, taking into account the quantity and quality of consolidated  
4 assets, earnings, potential earnings, availability or retained earnings, projected  
5 growth rates, liquidity, and capital requirements. ¶92. This information was not  
6 available to the public. The Finance Committee met ten times in 2006. ¶93.

7 The Operations and Public Policy Committee (Parry – Chair, Cunningham,  
8 Robertson) had oversight responsibility as to, among other things, the Company's  
9 operational objectives, including its public affairs public policy objectives,  
10 operational risk matters, and matters of responsible lending, fair lending and  
11 community lending programs. ¶95. Members of the Committee would have had  
12 access to material, non-public information related to the Company's lending  
13 programs, operational risk, and community lending programs. This Committee  
14 met five times in 2006. ¶96.

15 Finally, the Board's Compensation Committee (Snyder – Chair, Donato,  
16 Robertson) oversaw the compensation of the Company's directors, executives, and  
17 employees, including stock options and stock incentive awards. ¶¶83-84. The  
18 Compensation Committee would have had access to materials and information on  
19 the performance of Countrywide and various stock grant information so that they  
20 could evaluate the performance of the CEO and other executive officers in relation  
21 to their compensation. ¶84. The Compensation Committee met twenty-nine times  
22 during 2006. ¶85.

### 23 3. The Stock Repurchase Plan And Defendants' Insider Trading

24 The Complaint demonstrates that a majority of the Board is interested with  
25 respect to Plaintiffs' claims because they face a substantial likelihood of liability  
26 for engaging in illegal insider selling of Countrywide stock. As set forth above  
27 (and detailed below in § II.B.2.a), six of the nine directors engaged in heavy  
28

1 insider trading during the Relevant Period – *over \$570 million*<sup>9</sup> – before  
 2 Countrywide disclosed the severe problems it was having with its business that  
 3 were well known to the Board.<sup>10</sup>

4 Moreover, before the Company’s financial woes became public, the Board  
 5 initiated a \$2.5 billion share repurchase program to keep Countrywide’s stock price  
 6 inflated while the majority of the Board engaged in highly suspicious and massive  
 7 insider trading. ¶¶321-27; App. A. Normally, a stock repurchase plan is  
 8 implemented because a company’s directors believe the company’s stock is *below*  
 9 its true value and it has excess cash. Here, the stock repurchase program initiated  
 10 by the Defendants (and for which the Company lacked the cash to fund) caused  
 11 Countrywide’s share price to reach an *all-time high*.<sup>11</sup> The Director Defendants  
 12 knew, however, that Countrywide’s stock was, in fact, *not below* its true value, but  
 13 was artificially inflated as the Company had been falsely and misleadingly  
 14 inflating loan volume by disregarding its underwriting procedures and falsely  
 15 reporting earnings in violation of Generally Accepted Accounting Principles  
 16 (“GAAP”). Indeed, after implementing the plan, a majority of the Director

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 18 <sup>9</sup> Mozilo (\$474,491,038), Sambol (\$69,878,744), Cunningham (\$3,006,700),  
 19 Donato (\$4,345,868), Robertson (\$10,215,668), and Snyder (\$7,960,864). Russell  
 also sold \$371,243.

20 <sup>10</sup> *See Rales*, 634 A.2d 927; *see also Conrad v. Blank*, 940 A.2d 28, 38 (Del. Ch.  
 21 2007) (“Most obviously, both have a strong financial incentive to maintain the  
 22 status quo by not authorizing any corrective action that would devalue their current  
 23 holdings or cause them to disgorge improperly obtained profits. This creates an  
 24 unacceptable conflict that restricts them from evaluating the litigation  
 25 independently.”); *In re Gen. Instr. Corp. Sec. Litig.*, 23 F. Supp. 2d 867, 874 (N.D.  
 26 Ill. 1998); *Strougo v. Carroll*, 1991 WL 9978, at \*4 (Del. Ch. Jan. 29, 1991); *In re*  
 27 *Cendant Corp. Derivative Action Litig.*, 189 F.R.D. 117, 129 (D.N.J. 1999)  
 28 (excusing demand in a case involving falsified financial statements followed by  
 insider trading, complicated by a failure to maintain corporate financial records in  
 compliance with GAAP on the grounds that plaintiff had pled a reasonable doubt  
 as to the disinterestedness or independence of the majority of the directors in  
 office).

<sup>11</sup> For this reason, Plaintiffs’ explanation of the relation between the share  
 repurchase program and the insider trading is logical and reasonable, while  
 Defendants’ innocent explanation – that they were unrelated events – is decidedly  
 unreasonable. Given that the Court must draw all reasonable inferences in  
 Plaintiffs’ favor, the Court should accept Plaintiffs’ view of the facts alleged.

1 Defendants (and the Company’s management) sold much of their own personal  
2 holdings in suspicious amounts. In essence, the Director Defendants were forcing  
3 the Company to *buy* shares (with borrowed money), at the same time that the  
4 Director Defendants were personally *selling* shares – with six of the nine relevant  
5 Director Defendants “appear[ing] on both sides of a transaction.” *Aronson*, 473  
6 A.2d at 812; *cf. In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 990 (9th Cir.  
7 1999) (finding demand not waived where only 2 of 9 directors sold when  
8 repurchase plan was instituted).<sup>12</sup>

9 Unlike in *Computer Sciences* – repeatedly cited by Defendants – where the  
10 complaint raised a reasonable doubt as to the interestedness of only three of the  
11 seven board members (because they either wrongfully received a financial benefit  
12 or were on the relevant committee charged with oversight), here, the repurchase  
13 plan and the related insider trading raise a reasonable doubt as to the interestedness  
14 of *six of the nine* board members – well over a majority. *In re Computer Scis.*  
15 *Corp. Derivative Litig.*, 244 F.R.D. 580, 587-88 (C.D. Cal. July 24, 2007), *appeal*  
16 *docketed*, No. 07-56461 (9th Cir. Oct. 18, 2007).

17 Defendants also rely upon *Guttman v. Jen-Hsun Huang*, 823 A.2d 492 (Del.  
18 Ch. 2003) (dismissing a derivative insider trading claim for failure to plead  
19 demand futility), and *Rattner v. Bidzos*, 2003 WL 22284323 (Del. Ch.  
20 Oct. 7, 2003) (following *Guttman*). *Guttman* and *Rattner* are not only readily  
21 distinguishable, but actually support Plaintiffs’ position. In both cases, the courts  
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23  
24

25 <sup>12</sup> Defendants’ assertion that the timing of the sales more reasonably coincided  
26 with the expiration of a blackout period, or restriction on sales, is simply a red  
27 herring. CFC Mem. at 18 n.19. A purported blackout expiration, lifted after the  
28 announcement that Mozilo would stay on as CEO, does not explain the magnitude  
and timing of the sales. In fact, it is far more reasonable to infer that Defendants  
sold at inflated prices after announcing the repurchase program, which they  
instituted and from which they personally benefited.

1 identified precisely what facts were *not* pled that led to the dismissal.<sup>13</sup> Here, in  
2 contrast, the Complaint addresses the specific allegations of Board involvement  
3 found wholly lacking in *Guttman* and *Rattner*. The Complaint details each  
4 Director Defendant's participation on specific Board Committees, how many times  
5 each Committee met, and what types of information was reviewed by the Director  
6 Defendants. See § II.A.2, *supra*; see also ¶¶75-97 (detailing Board Committee  
7 duties). For example, through the various Committee assignments, the Director  
8 Defendants oversaw the integrity of the Company's financial statements, internal  
9 audit functions, allowances for loan losses, the Company's liquidity position,  
10 operational risk, lending practices, and executive compensation. See § II.A.2,  
11 *supra*; see also ¶¶75-97. Moreover, the Complaint goes even further and details  
12 the operations failings and financial misstatements known to the Director  
13 Defendants based on additional corroborating evidence, including information  
14 provided by former Countrywide employees. See § II.B.2.b, *infra*. Either the  
15 Director Defendants did their jobs and received (and concealed) the adverse  
16 material, non-public information that they traded on, or they turned a blind eye to  
17 the massive problems brewing at Countrywide.

18 **4. All Board Members Face A Substantial Likelihood**  
19 **Of Liability On The Lack Of Oversight Claims**

20 In addition to the insider trading allegations, Plaintiffs also satisfy *Aronson*  
21 and *Rales* as to the oversight claims by detailing that a majority, if not all, of the

22 \_\_\_\_\_  
23 <sup>13</sup> *Guttman*, 823 A.2d at 503 (“Entirely absent from the complaint are well-pled,  
24 particularized allegations of fact detailing the precise roles that these directors  
25 played at the company, the information that would have come to their attention in  
26 those roles, and any indication as to why they would have perceived the accounting  
27 irregularities”), and *Rattner*, 2003 WL 22284323, at \*34-35 (“[A]bsent from the  
28 particularized allegations of the Amended Complaint are the ‘precise roles that [the  
Director Defendants] played at the Company [and] the information that would have  
come to their attention in those roles.’ The Amended Complaint is also devoid of  
any particularized facts that could lead to the inference that the timing of the trades  
reflected the Selling Defendants’ impermissible insider trading” (quoting *Guttman*,  
823 A.2d at 503.)).

1 Director Defendants “‘face a substantial likelihood of liability’ that renders them  
2 ‘personally interested in the outcome of the decision on whether to pursue the  
3 claims asserted in the complaint,’ and are therefore not disinterested or  
4 independent.” *Stone v. Ritter*, 911 A.2d 362, 367 (Del. 2006) (citing *Rales*, 634  
5 A.2d at 934).

6 Defendants claim that Plaintiffs’ “failure of oversight” allegations are  
7 insufficient to excuse demand because of a lack of particularity. CFC Mem. at 8.<sup>14</sup>

8 As explained below, however, the Complaint alleges a series of wrongful acts  
9 (many of which are interrelated) which evidence a pattern of misconduct showing  
10 a wholesale abandonment or abdication of the Board’s fiduciary duties, including a  
11 lack of due care and oversight. *See* § II.B, *infra*.

12 Here, Countrywide’s Board (and its relevant Committees) was fully aware of  
13 the alleged problems facing Countrywide, because the suspect financials were right  
14 on the surface, visible to any Directors attending to fiduciary “duties in good  
15 faith.” *See Guttman*, 823 A.2d at 506; *infra*, § II.B. Further, the market was full of  
16 stories of increased delinquencies in home mortgages, especially in the particular  
17 non-traditional loans being pushed by Countrywide, yet the Board did nothing to  
18 ensure that Countrywide remained in a position of credible lending – as Mozilo  
19 was openly boasting to the market. Nor did the Board, including its various  
20 Committees, ensure that proper accounting was taking place with respect to the  
21

22 <sup>14</sup> Defendants rely on *Stone*, but omit that the plaintiffs’ in that case readily  
23 acknowledged that the directors neither “‘knew [n]or should have known that  
24 violations of law were occurring,’ *i.e.*, that there were no ‘red flags’ before the  
25 directors.” 911 A.2d at 364. By contrast, and as detailed in the scienter section  
26 below, the instant Complaint alleges that the Director Defendants were aware or  
27 should have been aware of the serious accounting issues raised in the Complaint,  
28 not only because they admitted that they were monitoring these issues, but because they participated on Board Committees with specific oversight responsibility as to these issues, and the Complaint details the various information that the Director Defendants knew throughout the Relevant Period. Despite this knowledge, the Director Defendants failed to exercise any oversight over these issues, all of which were central to Countrywide’s business and “critical” to its accurate reporting of financial results.

1 risk and hedging activities, failing to ensure that appropriate allowances for loan  
2 losses were taken. Here, the Board’s lack of action demonstrates “a sustained or  
3 systematic failure of the board to exercise oversight,” and “an utter failure to  
4 attempt to assure a reasonable information and reporting system exists.” *In re*  
5 *Caremark Int’l*, 698 A.2d 959, 971 (Del. Ch. 1996).

6 Courts excuse demand where a plaintiff demonstrates a lack of good faith by  
7 pleading a sustained or systematic failure to exercise oversight and assure accurate  
8 record keeping. *Id.* Meeting the *Caremark* standard, the Complaint here alleges  
9 that the Director Defendants failed to supervise and monitor a fraudulent scheme  
10 of “significant magnitude and duration.” *In re Oxford Health Plans*, 192 F.R.D.  
11 111, 117 (S.D.N.Y. 2000).<sup>15</sup>

12 The Sixth Circuit, in *McCall v. Scott*, 239 F.3d 808 (6th Cir. 2001), applied  
13 the *Caremark* standard and concluded that a pre-suit demand would have been  
14 futile on the company’s board of directors. Reversing the district court’s dismissal  
15 of the plaintiffs’ complaint, the Sixth Circuit determined that: (i) “the district court  
16 erred in concluding that only intentional conduct would escape the protection of  
17 the provision adopted” in defendant’s certificate of incorporation; and (ii) the  
18 particularized facts (drawing the reasonable inferences in plaintiffs’ favor) were  
19 sufficient to create a reasonable doubt as to the disinterestedness of a majority of  
20 the board, because the alleged facts presented a substantial likelihood of director  
21 liability for intentional or reckless breach of the duty of care. *Id.* at 819. In  
22 *McCall*, the complaint cited significant factors demonstrating that the board must  
23 have been aware of the alleged fraud, including: (1) “the prior experience of a  
24 number of the defendants as directors or managers” (which, the Court noted, was a  
25 “significant factor” in its assessment); (2) the existence of numerous federal

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27 <sup>15</sup> In *Oxford Health Plans*, the defendants, like Defendants here, unsuccessfully  
28 argued in their motion to dismiss that they “immediately took steps to respond to  
the Company’s unexpected and highly publicized problems.” *Id.* at 114.

1 investigations; and (3) numerous articles published in *The New York Times*  
2 regarding the alleged improprieties. *Id.* at 819, 822-23.

3 The facts alleged in the present Complaint are closely analogous to those  
4 found sufficient to excuse demand in *McCall*. For example, the Complaint details  
5 various investigative reports from *The New York Times* and *The Wall Street*  
6 *Journal* detailing alleged improprieties in Countrywide's lending practices and  
7 insider sales. *See, e.g.*, ¶¶113-17, 132, 180, 206, 342. Moreover, the Complaint  
8 details the various governmental investigations and legal proceedings resulting  
9 from the improper lending and accounting activities at Countrywide, including, for  
10 example, that the Company agreed to a settlement in late 2006 as a result of  
11 improper lending activities and that the SEC is investigating insider trading at the  
12 Company. *See, e.g.*, ¶¶185, 187, 273. Especially in combination with the  
13 confidential sources and other indicia of the Director Defendants' scienter set out  
14 below and the drastic effect on Countrywide's business, these allegations  
15 demonstrate Director Defendants' utter failure to ensure a reasonable information  
16 and reporting system, and demand should be excused.

17 More recently, Judge Colleen McMahon in the Southern District of New  
18 York denied the defendants' motion to dismiss on demand futility. *In re Veeco*  
19 *Instruments, Inc. Sec. Litig.*, 434 F. Supp. 2d 267 (S.D.N.Y. 2006). Like the  
20 instant Complaint, the *Veeco* plaintiffs alleged that the board, despite their  
21 meetings, took no actions to strengthen internal controls for more than a year  
22 following the discovery of a deficiency. *Id.* at 277. The court concluded: "This is  
23 not a case where the directors had 'no grounds for suspicion' or 'were blamelessly  
24 unaware of the conduct leading to the corporate liability,'" and, thus, demand was  
25 excused as futile. *Id.* at 278 (citing *Caremark*, 698 A.2d at 969). Likewise, the  
26 Complaint here alleges in detail the information known to the Director Defendants  
27 throughout the Relevant Period, yet they took no actions to investigate these  
28

1 matters involving Countrywide's core business operations, to ensure compliance  
 2 with underwriting standards, to increase the allowances for loan losses, or to  
 3 ensure accurate financial reporting.<sup>16</sup>

4 The conduct of the Director Defendants here is similar to the conduct of the  
 5 directors in the cases above, and the result reached by this Court should be the  
 6 same. Simply stated, demand is excused where, as here, the plaintiff alleges:

7 either (1) that the directors knew or (2) should have known that  
 8 violations of law were occurring and, in either event, (3) that the  
 9 directors took no steps in a good faith effort to prevent or remedy that  
 10 situation, and (4) that such failure proximately resulted in the losses  
 11 complained of.

12 *Caremark*, 698 A.2d at 971.<sup>17</sup>

13 **5. Plaintiffs Sufficiently Allege Demand Futility Regarding Waste**

14 **Countrywide argues that demand is not excused with respect to the**

15  
 16 <sup>16</sup> Directors of a Delaware corporation are expected to speak with each other when  
 17 serious problems arise in their company. In *Saito v. McCall*, the court observed  
 18 that a "committee of the board, acting in good faith, would have communicated  
 19 with each other concerning the accounting problems . . . and would have shared the  
 20 information with the entire . . . board of directors." 2004 WL 3029876, at \*7 n.71  
 21 (Del. Ch. Dec. 20, 2004). Accordingly, the court found that demand on the entire  
 Board would have been futile. *Id.* Likewise, the particularized allegations in the  
 Complaint give rise to a reasonable inference that a majority of Countrywide's  
 Board was aware of the systemic misconduct that gave rise to the collapse of the  
 Company's business, and that the Director Defendants failed to take necessary  
 steps to avert disaster. *See, infra*, § II.B.

22 <sup>17</sup> Likewise, Defendants' assertion that the exculpation provision of Countrywide's  
 23 charter, under Del. Corp. Code § 102(b)(7), warrants dismissal for breaches of  
 24 fiduciary duty involving bad faith, loyalty or intentional wrongdoing, is incorrect.  
 25 *See Emerald Partners v. Berlin*, 726 A.2d 1215, 1227 (Del. 1999) ("Section  
 26 102(b)(7) protections do not apply to violations of the fiduciary duties of good  
 27 faith or loyalty."). Moreover, this issue cannot be resolved via a motion to dismiss.  
 28 *See In re Tower Air, Inc.*, 416 F.3d 229, 237 (3d Cir. 2005) (finding that invocation  
 of Delaware's exculpatory statute is an affirmative defense not suitable for  
 consideration in a Rule 12(b)(6) motion); *see also Sanders v. Wang*, 1999 WL  
 1044880, at \*11 (Del. Ch. Nov. 8, 1999) ("I may not now properly consider  
 exculpatory provision. Defendants will have the opportunity to present their  
 affirmative defense as the case progresses. At this stage of the proceedings, I  
 cannot conclude as a matter of law that the Board acted in good faith and that their  
 actions constituted no more than mere carelessness.").

1 Complaint's waste claim because it "allege[s] in conclusory fashion that the Board  
2 lacks independence and is liable for breach of duty, mismanagement, and waste for  
3 the compensation the Board approved for Mr. Mozilo." CFC Mem. at 21.  
4 According to Countrywide, these allegations have not been pleaded with  
5 particularity that the "amounts approved were so egregious that a substantial  
6 likelihood of director liability exists." CFC Mem. at 21. This argument fails for  
7 several reasons.

8 First, Countrywide applies the wrong standard. The waste claims relate to  
9 specific Board actions and, therefore, is controlled by *Aronson's* test for demand  
10 excusal, not *Rales*. Second, the allegations easily meet the standard for demand  
11 futility under *Aronson*. At a minimum, the allegations cast a "reason to doubt" that  
12 the Director Defendants are independent, and/or that the decisions of the Board  
13 were the product of valid business judgment. Indeed, the waste claims encompass  
14 more than just the massive compensation to Mozilo; they also involve the stock  
15 repurchase program where the Board forced Countrywide to incur billions of  
16 dollars in debt to buy back stock while Defendants simultaneously sold their shares  
17 for over \$100 million in proceeds. ¶503. Tellingly, Countrywide's motion to  
18 dismiss is silent as to these devastating waste allegations.

19 With respect to specific board decisions, such as the Board's decision to  
20 approve of Mozilo's compensation, demand will be excused when there is a reason  
21 to doubt that: (1) a majority of the board is disinterested or independent or (2) the  
22 challenged acts were the product of the board's valid exercise of business  
23 judgment. *Aronson*, 473 A.2d at 814; *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch.  
24 2007). To excuse demand for lack of independence, a complaint need only show  
25 that the board is either dominated by an officer or director who is the proponent of  
26 the challenged transaction, "or that the board is so under the director or officer's  
27 influence that its discretion is 'sterilized.'" *Computer Scis.*, 244 F.R.D. at 586  
28

1 (citing *Rales*, 634 A.2d at 936); *Telxon Corp. v. Meyerson*, 802 A.2d 257, 264  
2 (Del. 2002). Importantly:

3 A director may also be deemed “controlled” if he or she is beholden to  
4 the allegedly controlling entity, as when the entity has the direct or  
5 indirect unilateral power to decide whether the director continues to  
6 receive a benefit upon which the director is so dependent or is of such  
7 subjective material importance that its threatened loss might create a  
8 reason to question whether the director is able to consider the  
9 corporate merits of the challenged transaction objectively.

10 *Telxon*, 802 A.2d at 264. Further, “[l]ike any other interested transaction,  
11 directorial self-compensation decisions lie outside the business judgment rule’s  
12 presumptive protection . . . [thus] the receipt of self-determined benefits is subject  
13 to an affirmative showing that the compensation arrangements are fair to the  
14 corporation.” *Id.* (citations omitted).

15 a. The Directors Are Not Independent

16 The allegations in the Complaint are sufficient to, at a minimum, cast a  
17 reasonable doubt as to the independence of the Board, especially those members  
18 sitting on the Compensation Committee (Defendants Donato, Robertson, and  
19 Snyder) who approved the outlandish pay packages for Mozilo. The Complaint  
20 makes clear that, as far as the Director Defendants were concerned, Countrywide  
21 was Mozilo’s Company. Mozilo was a co-founder and has been Chairman since  
22 1999 and CEO since 1998. ¶54. In his position, he dominated the other Board  
23 members and directed the overall selection of the Board at Countrywide. ¶460.  
24 Countywide ignores the entire context of the demand allegations and the inferences  
25 that can be drawn from those allegations. Delaware law provides that a reasonable  
26 doubt exists regarding director independence if that officer/director might  
27 reasonably be influenced in responding to demand based on “extraneous  
28

1 considerations or influences” rather than just the corporate merits of the demand  
2 letter. *Steiner v. Meyerson*, 1995 WL 441999, at \*9 (Del. Ch. July 19, 1995)  
3 (citing *Rales* and *Aronson*); *see also Computer Scis.*, 244 F.R.D. at 589  
4 (concluding that a member of compensation committee could not have impartially  
5 considered a demand).

6 While Delaware has long held that mere payments of directors’ fees alone  
7 are not enough to create a conflict of interest, *see, e.g., Grobow v. Perot*, 539 A.2d  
8 180 (Del. 1988) overruled on other grounds, *Brehm*, 746 A.2d 244, those same  
9 courts recognize that “a situation might arise where directors’ compensation, in the  
10 form of ‘directors’ fees,’ becomes so lavish that a mechanical application of the  
11 presumption would be totally at variance with reality.” *Grobow v. Perot*, 526 A.2d  
12 914, 923 n.12 (Del. Ch. 1987) *aff’d*, 539 A.2d 180 (Del. 1988). In *Orman v.*  
13 *Cullman*, 794 A.2d 5 (Del. Ch. 2002), the Chancery Court confirmed that  
14 directors’ fees do not create a conflict, but only so long as the compensation does  
15 not exceed customary bounds: “[T]he disqualifying effect of such fees might be  
16 different if the fees were shown to exceed materially what is commonly understood  
17 and accepted to be a usual and customary director’s fee.” 794 A.2d at 29 n.62.<sup>18</sup>

18 Here, the Director Defendants’ compensation presents such a situation  
19 where it is appropriate to depart from the general rule. Countrywide’s Directors  
20 were compensated in astronomical sums that would be material to anyone’s  
21 financial picture.<sup>19</sup> As detailed in the Complaint, the relevant Director Defendants’  
22 independence was compromised long ago because Countrywide management  
23

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24 <sup>18</sup> *See also Nat’l Auto Credit*, 2003 WL 139768 (finding that the lavish director  
25 fees at issue established a conflict); *A.R. Demarco Enters. v. Ocean Spray*  
*Cranberries*, 2002 WL 31820970, at \*5 n.13 (Del. Ch. Dec. 4, 2002).

26 <sup>19</sup> *Nat’l Auto Credit*, 2003 WL 139768, at \*11 (finding that director pay packages  
27 were “material” even though “no detailed showing has been made as to the  
28 [Directors’] financial status, [because] it is a reasonable inference, drawn from the  
Complaint’s particularized facts, that such amounts are material, and, thus, I  
conclude that the Complaint does state a reasonable basis to question their  
disinterestedness”).

1 (namely, Mozilo) “paid for” his Board’s loyalty. ¶¶460-63. According to an  
2 article published in *The Wall Street Journal* and cited in the Complaint, the  
3 lucrative pay received by the Countrywide Board members “rewards board  
4 members so well that ‘at some point, you cross the line between paying for  
5 services provided and a very lucrative thing where board members aren’t going to  
6 challenge management . . . [and] they have crossed that line.” ¶461. The Director  
7 Defendants’ pay packages included restricted stock grants with an aggregate value  
8 equal to \$220,000, the right to participate in health plans, and the right to receive  
9 reimbursement for spousal travel. ¶462. In addition to the prestige of sitting on  
10 the Board of one of the largest mortgage lenders in the country, the Director  
11 Defendants had the right to designate charitable contributions of up to \$1 million  
12 “ratably over five years” and have the Company match contributions up to \$5,000  
13 on a yearly basis. ¶462. Further, the Complaint details that each member of the  
14 Compensation Committee earned well over \$400,000 in 2006, with all Board  
15 members making at least \$350,000 that year alone. ¶463. According to the  
16 Company’s 2007 Proxy, Director Defendant Parry, who sits on several other  
17 Boards and is a member of Countrywide’s Audit and Ethics Committee, took in  
18 \$538,824 for his part-time Board service. ¶463.

19 Countrywide claims that Defendant Mozilo does not set the compensation  
20 for the Board, rather the Compensation Committee sets such fees. CFC Mem. at  
21 23. This argument lacks merit, however, and misses the point. The Directors’  
22 compensation, whether determined by Mozilo or the Compensation Committee  
23 itself, is to be viewed in the context of the first prong of *Aronson*. Thus, there is at  
24 least a reasonable doubt that the amount of compensation received by the Director  
25 Defendants affected their independence when considering a demand upon the  
26 Company alleging waste with respect to the determination of Mozilo’s  
27 compensation. The Complaint’s allegations directly challenge the compensation  
28

1 that the Director Defendants were paying themselves, the very same Directors who  
2 were setting the compensation for Mozilo. The amount of compensation received  
3 by the Director Defendants also clearly exceeds the norm, and the Complaint sets  
4 forth news articles raising this very issue, demonstrating a “reason to doubt” under  
5 the authorities cited above, and demand is excused.

6 b. The Board’s Compensation Decisions Were  
7 Not Valid Exercises Of Business Judgment

8 Under the second prong of *Aronson*, demand is to be excused if the  
9 allegations cast “reason to doubt” that the transactions at issue were otherwise the  
10 product of valid business judgment. *Aronson*, 473 A.2d at 814; *accord Grimes v.*  
11 *Donald*, 673 A.2d 1207, 1216 (Del. 1996). To allege demand futility under this  
12 standard, “plaintiffs must plead particularized facts sufficient to raise (1) a reason  
13 to doubt that the action was taken honestly and in good faith or (2) a reason to  
14 doubt that the board was adequately informed in making the decision.” *In re Walt*  
15 *Disney Co. Deriv. Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003). The Complaint here  
16 contains particularized allegations raising a “reason to doubt” that approval of  
17 Mozilo’s and Sambol’s compensation was the product of valid business judgment.  
18 Indeed, Countrywide has entirely failed to address this issue, incorrectly asserting  
19 that *Rales* controls in this instance.<sup>20</sup>

20 Demand is to be excused here because the Complaint alleges, among other  
21 things, that:

- 22 • The Compensation Committee (Defendants Snyder, Cunningham, Donato  
23 and Robertson) directly participated in the grants to Defendants Mozilo and  
24

25 <sup>20</sup> Citing *Rales*, Countrywide argues that only Mozilo was interested in his own  
26 compensation, and therefore the other Directors “can only be interested if they face  
27 a substantial likelihood of liability for breach of fiduciary duty and waste.” CFC  
28 Mem. at 23. Even if the *Rales* test were applicable in this case, however, the  
allegations in the Complaint are specific enough to establish that there is a  
substantial likelihood of liability on the part of the Directors for approving  
Mozilo’s outlandish compensation packages.

1 Sambol of enormous compensation packages enabling their massive insider  
2 selling (§439);

- 3 • The Compensation Committee knew or recklessly disregarded that it was  
4 approving compensation in a manner that was not an exercise of valid  
5 business judgment (§441);
- 6 • Mozilo received millions in salary, bonuses and other types of  
7 compensation, totaling more than \$118 million in a four-year period (§442);
- 8 • In 2006, Mozilo received a total package of \$48.1 million, including option  
9 awards of \$23 million (§444);
- 10 • Mozilo’s compensation ranked him seventh in total compensation among all  
11 CEOs, well ahead of CEOs at much larger financial companies (§446);
- 12 • Although set to retire, the Board awarded Mozilo a retirement  
13 “reimbursement” that would pay \$10 million over the next three years –  
14 described as a one-of-a-kind arrangement (§447);
- 15 • Mozilo’s employment contract was changed to eliminate a key formula that  
16 would calculate his incentive award based on earnings per share growth  
17 (§448);
- 18 • Elimination of earnings per share growth as part of the formula directly  
19 corresponded with the new climate of decreasing earnings per share numbers  
20 (§450);
- 21 • The Board’s actions have led the “Corporate Library” to rate Countrywide  
22 an “F” with respect to its compensation packages, the lowest possible mark  
23 (§451); and
- 24 • The outlandish pay has led to disputes with major shareholders (§452).

25 Even more important than the staggering compensation figures set forth in  
26 the Complaint, three particularized events detailed in the Complaint establish that  
27 the Board, and the Compensation Committee of the Board, were dominated and  
28

1 controlled by Mozilo with regard to compensation matters.

2 First, Mozilo's compensation, when compared with the Compensation  
3 Committee Charter's benchmarks, shows that the Committee simply failed to  
4 consider any of the purported benchmarks so that it could continue awarding  
5 Mozilo super-sized pay packages without regard for the Company's performance  
6 or best interests. ¶443. Second, as alleged in the Complaint, *The Wall Street*

7 *Journal* published an article titled "Countrywide Directors' Dilemma," which  
8 detailed how the Company's Directors approved Mozilo's 2004 pay package over  
9 the objection of the Company's hired independent compensation adviser. ¶445.

10 The consultant advised the Directors to slim the pay package, partly by revamping  
11 the bonus formula, which paid Mozilo the same bonus as the prior year, even  
12 though the growth of the Company remained flat. *Id.* When Mozilo balked,

13 however, the Compensation Committee kept the formula and removed the  
14 consultant. *Id.* Finally, when it became apparent that Countrywide's business and

15 its share price were tanking, the Board allowed Mozilo to adopt two additional  
16 10b5-1 trading plans, and to amend one shortly thereafter, all of which permitted  
17 him to accelerate the speed at which he divested himself of his equitable ownership  
18 of the Company, while in the possession of material, non-public information. *See*  
19 Countrywide's Request for Judicial Notice ("CFC RJN"), Exs. 24-26; *see also*  
20 § II.B.2.a, *infra*.

21 Each one of these abdications of fiduciary duties, taken alone, is sufficient to  
22 establish that the Board's discretion is sterilized because of its lack of  
23 independence brought about by Mozilo's domination and control. Taken together,  
24 at the very least, these particularized allegations cast a "reason to doubt" that the  
25 Board's "decisions" with respect to Mozilo's compensation were made with good  
26 faith and as part of a rational exercise of business judgment, instead of just a  
27  
28

1 rubber stamp of Mozilo's wishes.<sup>21</sup>

2 Finally, one related case demonstrates that demand on the Board would have  
3 been futile. In early October 2006, LAMPERS sent Countrywide a formal demand  
4 for the inspection of its books and records under § 220 of the Delaware  
5 Corporations Law, seeking, among other things, documents relating to the  
6 Company's option grants to Directors and senior officers, including Mozilo. The  
7 Board promptly rejected LAMPERS' demand. LAMPERS wrote a second letter to  
8 Countrywide, making another demand on Countrywide and providing further  
9 evidence of the appropriateness of its purpose for seeking inspection of the  
10 requested books and records. The Company again rejected LAMPERS' demand.  
11 Given the Company's steadfast refusal to permit LAMPERS to exercise its rights  
12 as a shareholder, LAMPERS filed suit in the Delaware Court of Chancery. After a  
13 trial before Vice Chancellor Noble, the court issued an Opinion and Order  
14 granting, in large part, LAMPERS' demand and ordering Countrywide to provide  
15 LAMPERS access to certain books and records. *See LAMPERS v. Countrywide*  
16 *Fin. Corp.*, No. 2608-VCN (Del. Ch. Oct. 2, 2007). The Board's previous  
17 rejections of Lead Plaintiff LAMPERS' demand demonstrates that demand in this  
18 case would have been futile.

19 For the reasons set forth above, demand in this case is excused.<sup>22</sup>

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21 <sup>21</sup> *See Cal. Pub. Employees Ret. Sys. v. Coulter*, 2002 WL 31888343, at \*13  
22 (“[w]hen it appears that the disinterested directors deferred to an interested party in  
23 all decisions related to the transaction, demand is appropriately excused under the  
24 second prong of *Aronson* because there is a reasonable doubt whether the decision  
25 ‘was the product of considered business judgment of independent directors’”) (citing *Kahn v. Tremont Corp.*, 1994 WL 162613, at \*1-2 (Del. Ch. Apr. 22, 1994) (finding an independent basis, under the second prong of *Aronson*, for excusing Rule 23.1 demand)).

26 <sup>22</sup> Additionally, Countrywide briefly contends that Plaintiffs have not sufficiently  
27 alleged standing. CFC Mem. at 25. While the allegations in the Complaint,  
28 accepted as true, are typically sufficient to establish shareholder standing, Countrywide contends that federal courts in California require more. *Id.* (citing *In re Verisign, Inc., Derivative Litig.*, 531 F. Supp. 2d 1173, 1202 (N.D. Cal. 2007); *In re Computer Scis. Corp. Derivative Litig.*, 2007 WL 1321715, at \*15 (C.D. Cal.

1 B. The Complaint States A Claim Under Section 10(b)

2 A complaint states a claim under § 10(b) of the Exchange Act if it alleges:  
3 (1) a material misrepresentation or omission (2) scienter; (3) reliance; (4) economic  
4 loss; and (5) loss causation – a causal connection between the misrepresentation  
5 and the loss. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005).

6 1. The Complaint Pleads False Statements With Particularity

7 Under the Private Securities Litigation Reform Act of 1995 (“PSLRA”), a  
8 complaint sufficiently alleges false or misleading statements by “specify[ing] each  
9 statement alleged to have been misleading” and “the reason or reasons why the  
10 statement is misleading.” 15 U.S.C. § 78u-4(b)(1)(B). Accordingly, a complaint  
11 sufficiently pleads falsity where it includes the statements or omissions alleged to  
12 be misleading, the reasons why each was misleading, and the facts upon which that  
13 belief is formed. *See Desaigoudar v. Meyercord*, 223 F.3d 1020, 1023 (9th Cir.  
14 2000). The Ninth Circuit “recognize[s] that statements literally true on their face  
15 may nonetheless be misleading when considered in context.” *Miller v. Thane Int’l,*  
16 *Inc.*, 508 F.3d 910, 916 (9th Cir. 2007). Here, the Complaint identifies  
17 Defendants’ false and misleading statements and omissions, explains why each  
18 was false and misleading when made, and pleads particularized facts supporting  
19 the allegations. ¶¶275-305.

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24 Mar. 26, 2007)). Both cases cited by Countrywide are distinguishable. First, in  
25 *Verisign*, plaintiffs ambiguously alleged that they had “owned VeriSign stock  
26 during the Relevant Period,” which the court found to be inadequate since their  
27 status as shareholders “at all time relevant to the transactions challenged in the  
28 [complaint]” was not established.” 531 F. Supp. 2d at 1202. In *Computer*  
*Sciences*, in addition to pleading in vague terms, the plaintiffs contradicted  
themselves in their briefing and at oral argument as to when they owned stock in  
the nominal defendant. 2007 WL 1321715, at \*15. In any event, Plaintiffs here  
have filed verifications setting forth in detail the dates of Plaintiffs’ ownership of  
Countrywide stock. (Dkt. No. 107).

a. Defendants' Statements About Underwriting Standards, Risk Management, And Loan Quality Were Misleading

Throughout the Relevant Period, Defendants repeatedly made false and misleading statements concerning the most important aspects of Countrywide's business – the quality of its lending practices and loans on its balance sheet, as well as its ability to manage risk. For instance, the Company's Form 10-Ks (which were signed by the Director Defendants) falsely assured investors that the Company employed loan origination and underwriting standards to ensure that Countrywide originated only "high quality loans." *See, e.g.*, ¶288 ("Our loan origination standards and procedures are designed to produce high quality loans."). Similarly, the Company's Form 10-Ks repeatedly misrepresented that the Company retained only "high quality" loans on its balance sheet, reducing the Company's exposure to credit risk. *See, e.g.*, ¶287 ("We manage mortgage credit risk principally by securitizing substantially all mortgage loans that we produce, and by only retaining high credit quality mortgages in our loan portfolio."). The Company's Credit Risk Management disclosures in its Form 10-Ks also falsely stated that it employed "uniform" underwriting requirements to ensure that Countrywide "manage[d] credit risk to maintain credit losses within levels that achieve our profitability and return on capital objectives." ¶288.

Defendants' false and/or misleading statements were not limited to the Form 10-Ks. For example, in analyst conference calls, Defendants repeatedly, but falsely, asserted that Countrywide was a "disciplined" lender. *See, e.g.*, ¶281. Defendants assured investors that the Company's loan products were not inherently risky, *see, e.g.*, ¶284, and assured investors that the Company was more conservative than its competitors who engaged in risky lending practices. *See, e.g.*, ¶281 ("I think using what our competitors do as a barometer will put you down the wrong path. We are a very different focused company..."); ¶299 (distinguishing

1 Countrywide from New Century, Nova Star and Accredited Home Lenders).  
2 Defendant Mozilo repeatedly downplayed the Company's exposure to subprime  
3 loans, claiming that Countrywide's loan products were not as risky as subprime  
4 loans. *See, e.g.*, ¶¶144-45. Defendants also repeatedly misrepresented and failed  
5 to disclose that: (1) the Company had abandoned its underwriting standards and  
6 was originating loans to clearly risky borrowers, ¶¶141-89; (2) the Company was  
7 providing these risky borrowers with inherently more risky types of loans, ¶¶119-  
8 31; and (3) the Company was making more of these risky loans and maintaining  
9 increasing numbers of the loans on its own balance sheet. ¶¶111-12; 116-18.

10 Defendants assert that their statements (examples of which are set forth  
11 above) were not misleading because "absent from the Complaint are allegations  
12 that CFC lacked a credit policy, underwriting guidelines, or loan origination  
13 standards and procedures." Ind. Defs.' Mem. at 16. Defendants misconstrue the  
14 allegations. The Complaint does not plead that the statements were materially  
15 misleading because the Company had *no* credit policies or loan origination  
16 standards and procedures; rather, it was misleading for Defendants to repeatedly  
17 reference the policies and standards while at the same time the Company was  
18 ignoring these policies and standards so it could artificially inflate loan volume and  
19 misleadingly increase the Company's publicly reported earnings. *See, e.g.*, ¶¶141-  
20 74. Defendants' failure to disclose the Company's rampant deviations from its  
21 underwriting policies and procedures states a claim for securities fraud.<sup>23</sup>

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26 <sup>23</sup> *See, e.g., Atlas v. Accredited Home Lenders Holding Co.*, 2008 WL 80949, at  
27 \*4, \*9 (S.D. Cal. Jan. 4, 2008) (denying motion to dismiss where "Defendants  
28 allegedly caused Accredited's employees to disregard the company's stated  
underwriting guidelines in an effort to increase the volume of loans originated by  
Accredited" and noting that "underwriting practices would be among the most  
important information looked to by investors").

b. Defendants' Manipulation Of  
Countrywide's Allowances For Loan Losses

“[F]inancial statements that are not prepared in conformity with [GAAP] are presumed to be misleading and inaccurate.”<sup>24</sup> To plead a “violation of GAAP . . . , the plaintiff must show with particularity how the adjustments affected the company’s financial statements and whether they were material in light of the company’s overall financial position.” *In re Daou Sys.*, 411 F.3d 1006, 1018 (9th Cir. 2005) (reversing dismissal where district court found accounting subjective). Here, the Complaint details how the Company’s financial statements during the Relevant Period were prepared in violation of GAAP and how Defendants’ manipulations were material.

For example, Defendants inflated Countrywide’s reported income by hundreds of millions of dollars by understating the Company’s allowances for loan losses. ¶¶190-209. As a result, the Company’s financial results were not in compliance with GAAP, causing each of the Company’s press releases and SEC filings that published quarterly or yearly financial results to be false and/or misleading. ¶¶276-79, 291. In addition, failure to comply with GAAP also rendered false and/or misleading a number of Defendants’ other statements, including those statements concerning the effectiveness of the Company’s internal controls, *see, e.g.*, ¶291, the Company’s ability to mitigate credit risk, *see, e.g.*, ¶¶287-88, whether the Company was comparable to sub-prime lenders, *see, e.g.*, ¶¶299-300, and the Company’s prospects, creditworthiness and likelihood of suffering a debilitating liquidity crisis. *See, e.g.*, ¶¶301-04. By fraudulently inflating the Company’s income, and inadequately establishing allowances for loan losses, Defendants were able to conceal the true financial condition of the

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<sup>24</sup> *Goldstein v. MCI Worldcom*, 340 F.3d 238, 249 (5th Cir. 2003) (citing SEC Regulation S-X, 17 C.F.R. § 210.4-01(a)(1)); *In re Adaptive Broadband Sec. Litig.*, 2002 WL 989478, at \*12 (N.D. Cal. Apr. 2, 2002) (same).

1 Company.

2 Defendants ignore Ninth Circuit precedent with respect to actionable claims  
3 related to manipulations of loan loss reserves. In *In re Wells Fargo Sec. Litig.*, the  
4 Ninth Circuit held that the shareholders were “correct” in pointing out “that the  
5 deliberate failure to recognize problem loans, thus understating the reserve,  
6 constitutes an actionable omission or misrepresentation of existing fact which  
7 cannot be dismissed as a mere matter of internal mismanagement, unsound  
8 business practice, or poor accounting judgment.” 12 F.3d 922, 926 (9th Cir.  
9 1993).<sup>25</sup>

10 Rejecting many of the arguments that Defendants make here, the Ninth  
11 Circuit further stated: “There is nothing unique about representations and  
12 omissions regarding loan loss reserves that removes them from the purview of the  
13 antifraud provisions of the federal securities laws. In our view a reasonable  
14 investor would be influenced significantly by knowledge that a bank has  
15 knowingly or recklessly hidden its true financial status by deliberately misstating  
16 its level of non-performing loans, failing to provide adequate reserves, and  
17 indulging its problem loan customers.” *Id.*

18 As the defendants unsuccessfully attempted in *Wells Fargo*, Defendants here  
19 contend that setting reserves is an exercise of “judgments and estimates” and that  
20 “such judgment-driven accounting determinations” are “routinely dismissed.” Ind.  
21 Defs.’ Mem. at 9. *Wells Fargo* flatly rejected this assertion. 12 F.3d at 927. More  
22 recently, Judge Marilyn Huff of the Southern District of California similarly  
23 rejected these same arguments in denying defendants’ motions to dismiss a  
24 complaint alleging “Defendants manipulated earnings by inadequately reserving  
25 for defaults on mortgage loans held by the company for investment.” *Accredited*,

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27 <sup>25</sup> *Superseded by statute on other grounds as recognized in, Howard v. Everex*  
28 *Sys., Inc.*, 228 F.3d 1057, 1063 (9th Cir. 2000.)

1 2008 WL 80949, at \*4; *see also Lewis v. Straka*, 2008 WL 590863 (E.D. Wis.  
2 Mar. 3, 2008) (same). In short, there is no exception to the federal securities laws  
3 for manipulations of loan loss allowances.<sup>26</sup>

4 Defendants also contend that the Complaint pleads fraud by hindsight. Ind.  
5 Defs.' Mem. at 12. This argument was also rejected in *Wells Fargo*. *See* 12 F.3d  
6 at 927 (“this is neither a case second-guessing decisions by management nor one  
7 alleging ‘fraud by hindsight’; rather, the shareholders have specifically identified  
8 facts omitted by Wells Fargo”). Here, as in *Wells Fargo*, the Complaint alleges  
9 that Defendants “knew of certain ‘contingencies’ which rendered [Countrywide’s]  
10 loan reserves ‘inadequate,’ and failed to disclose this information.” *Id.* at 927.  
11 Defendants failed to disclose that the Company deviated from its publicly-stated  
12 underwriting policies to inflate revenues and earnings. ¶¶141-74. At the same  
13 time, the Company was originating significantly more risky types of loans, ¶¶107-  
14 31, retaining increasing amounts of those loans on the Company’s balance sheet,  
15 ¶118, and maintaining allowances for loan losses at low historic levels far below  
16 industry peers. ¶206. Originating riskier types of loans to less creditworthy  
17 individuals would naturally require the Company to increase its allowance for loan  
18 losses from historic levels. By failing to increase the allowance for loan losses,  
19 and failing to disclose that the Company was deviating from its disclosed  
20 underwriting procedures, Defendants misled investors and violated § 10(b) and  
21

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22 <sup>26</sup> Defendants quote *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990), a  
23 case against an auditor, for the proposition: “If all that is involved is a dispute  
24 about the time of the writeoff, based on estimates of the probability that a  
25 particular debtor will pay, we do not have fraud; we may have negligence.” Ind.  
26 Defs.' Mem. at 9. In *Dileo*, however, plaintiffs failed to plead any facts “to  
27 distinguish their situation from that of many others who are adversely affected by  
28 business reverses.” 901 F.2d at 627. Here, Plaintiffs do not contend that  
Countrywide’s allowance for loan losses was understated because of some  
surprising change in circumstances. On the contrary, the allowance was  
understated because the Company kept the allowance at historic low levels despite  
providing riskier loan products to riskier borrowers in violation of the Company’s  
own underwriting standards.

1 Rule 10b-5. The Complaint does not plead “fraud-by-hindsight” as it does not  
2 merely rely upon the fact that the Company was forced to increase its allowance  
3 for loan losses by billions of dollars; Countrywide’s collapse and forced increase  
4 of the allowance for loan losses add additional support to the already well-pleaded  
5 allegations that the allowances for loan losses were never properly established.

6 Defendants argue that, because Countrywide has yet to restate its financial  
7 results, Plaintiffs have a “heavy burden” to overcome in showing falsity. Ind.  
8 Defs.’ Mem. at 9. To plead falsity, however, there is no prerequisite that the  
9 Company admit its financials were false by issuing a restatement. *See, e.g.,*  
10 *Accredited*, 2008 WL 80949 (upholding § 10(b) accounting claims against  
11 subprime lender that did not restate its audited financial results). To hold  
12 otherwise would strip this Court of the powers vested in it by Congress, and enable  
13 Defendants to insulate themselves from liability by refusing to admit the falsity of  
14 their prior statements.<sup>27</sup>

15 c. Defendants’ False And Misleading Statements  
16 Concerning The Company’s Hedging Activities

17 Throughout the Relevant Period, the Company’s reported earnings and  
18 balance sheet were directly affected by valuations of the Company’s mortgage  
19 servicing rights (“Mortgage servicing rights”), retained interests, and inventory of  
20 loans held for sale. ¶210. The Company purportedly smoothed its earnings by the  
21 use of hedging activities, which, according to the Company’s SEC filings and press  
22 releases, acted as a counter-balance to fluctuations in the valuation of the  
23 Company’s mortgage servicing rights, residual interests and loans held for sale.

24 \_\_\_\_\_  
25 <sup>27</sup> *See, e.g., Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 83 (1st Cir. 2002) (The  
26 lack of a restatement “does not end [plaintiff’s] case when he has otherwise met  
27 the pleading requirements of the PSLRA. To hold otherwise would shift to  
28 accountants the responsibility that belongs to the courts. It would also allow  
officers and directors of corporations to exercise an unwarranted degree of control  
over whether they are sued, because they must agree to a restatement of the  
financial statements.”).

1 ¶¶213-14, 216. Hedges are used to reduce/eliminate the risk associated with a  
2 specific investment. In truth, Countrywide’s hedges were ineffective and the  
3 Company suffered losses of over \$2.6 billion as a result. ¶¶217-19. According to  
4 Confidential Witness (“CW”) 11, it was apparent that the Company’s hedging  
5 methodology was ineffective at least as early as 2006 – the Company’s hedging  
6 investments were not offsetting losses from poorly performing loans in the  
7 Company’s portfolio monitored by CW11. ¶¶221-30. **Indeed, the hedging  
8 relationship was so poor that CW11 was personally instructed to falsify the  
9 Company’s hedging data *retroactively* to make it appear as if the Company’s  
10 hedging activities were effective.** ¶224. Defendants do not dispute that the  
11 Company’s hedges were ineffective in offsetting the poor performance of the  
12 Company’s loans, nor do Defendants challenge the accounts of CW11 or CW12,  
13 who are former employees in senior positions at Countrywide and were in  
14 positions to know that the Company’s hedging models did not work and that this  
15 was a Company-wide problem. ¶¶221-29.

16 Defendants instead argue that the Complaint fails to allege any false  
17 statements in connection with the Company’s hedging activities because “[m]erely  
18 alleging that a hedge was ineffective from an *economic* perspective *i.e.*, that it did  
19 not mitigate as much risk as it should have – does not demonstrate an *accounting*  
20 violation.” Ind. Defs.’ Mem. at 14 (emphasis in original). Defendants’ argument  
21 fails in several respects. **First, the Complaint need not allege a technical  
22 accounting violation to plead a false and/or misleading statement in violation of  
23 § 10(b).<sup>28</sup> Second, Defendants falsely assured the market that the Company’s**  
24

25  
26 <sup>28</sup> See, e.g., *SEC v. Arthur Young & Co.*, 590 F.2d 785, 788-89 (9th Cir. 1979)  
27 (even “compliance with Generally Accepted Accounting Principles (GAAP) [will]  
28 not immunize [one who chooses] not to disclose on a financial statement a known  
material fact”); *In re Terayon Commc’ns Sys.*, 2002 WL 989480, at \*5-6 (N.D.  
Cal. Mar. 29, 2002) (manipulation of earnings need not violate GAAP to be  
actionable).

1 hedging activities were effective and would “mitigate negative valuation changes”  
 2 or “moderate the effect” of declines in the various loan portfolios, ¶¶213-14, 216,  
 3 which they did not. ¶¶217-19. Defendants *never* disclosed that the “hedges” did  
 4 not really hedge; nor did Defendants ever tell investors that the “hedges” were  
 5 ineffective from an economic perspective. If the hedges did not work from an  
 6 “economic perspective,” then Defendants should not have referred to them as  
 7 hedges. Finally, Defendants provide no basis to suggest that there is any difference  
 8 between hedging effectiveness from an “economic” perspective versus an  
 9 “accounting” perspective. For a hedge to qualify as a hedge, it must significantly  
 10 reduce the risk of valuation fluctuations. Defendants misled investors by failing to  
 11 disclose that, at least as early as 2006, Countrywide’s hedges were not effective in  
 12 countering the dismal performance of loans in the Company’s loan portfolios.<sup>29</sup>

13 d. Defendants Misleadingly Assured The Market Regarding  
 14 Countrywide’s Business Operations And Liquidity

15 In late August 2007, Defendant Mozilo falsely and misleadingly chastised an  
 16 analyst whose independent evaluation led him to conclude that Countrywide might  
 17 face liquidity constraints. ¶303. Mozilo called the assertion “totally irresponsible  
 18 and baseless,” and he further misled investors by stating: “I can tell you there is no  
 19 more chance for bankruptcy today for Countrywide than it was six months ago,  
 20 two years ago, when the stock was \$45 a share. [We] are a very solid company.”

21 *Id.* Mozilo certainly did not disclose the whole truth, including material facts  
 22 concerning the Company’s true business practices and falsified financial results.  
 23 Indeed, by the end of the third quarter (ending September 31, 2007), the Company

24  
 25 <sup>29</sup> Defendants incorrectly assert that “FAS 133 did not even apply to the  
 26 Company’s hedging activities in 2006 and 2007 . . . .” Ind. Defs.’ Mem. at 14 n.7.  
 27 The Company continued to be subject to FAS 133 hedge accounting for certain of  
 28 its risk management activities, including accounting for its inventory of loans held  
 for sale, through the end of 2007, and the Company has admitted: “With the  
 market disruption in late 2007, we were not able to qualify a significant portion of  
 our non-conforming Prime Mortgage Loan inventory for hedge accounting.” See  
 Plaintiffs’ Request for Judicial Notice (“RJN”), Ex. 1.

1 had been forced to borrow over \$51 billion from the Federal Home Loan Bank  
 2 System to keep afloat. ¶270. By January 2008, only a few months after Mozilo  
 3 had assured investors that the Company was “very solid,” its stock had collapsed  
 4 on credit fears and the Company was being sold for a small fraction of its former  
 5 valuation. ¶¶271, 343.

6 e. Outside Directors Made False Or Misleading Statements

7 Although Dougherty and the Individual Defendants argue that the Outside  
 8 Directors made none of the alleged false statements, the Complaint alleges that the  
 9 Outside Directors signed the Company’s materially false and misleading Forms  
 10 10-K during the Relevant Period.<sup>30</sup> ¶¶288-90. The Company’s Forms 10-K  
 11 included the Company’s false and misleading financial statements, and falsely  
 12 assured investors that the Company properly managed credit risk. ¶¶287-97. This  
 13 is sufficient to plead that the Outside Directors “made” a false statement. *Howard*  
 14 *v. Everex Sys.*, 228 F.3d 1057, 1061 (9th Cir. 2000) (a “director signing a  
 15 document filed with the SEC . . . ‘makes or causes to be made’ the statements  
 16 contained therein.”) Indeed, “a director who has the requisite level of scienter and  
 17 signs a fraudulent Form 10-K can be liable as a primary violator of § 10(b) for  
 18 making a false statement.” *Howard*, 228 F.3d at 1061.<sup>31</sup> Accordingly,  
 19 Defendants’ contention that the Complaint relies upon “group pleading” to allege  
 20

21 <sup>30</sup> Defendant Dougherty signed Countrywide’s Form 10-Ks for the years ended  
 22 December 31, 2004, 2005, and 2006.

23 <sup>31</sup> See also *Middlesex Ret. Sys. v. Quest Software Inc.*, 527 F. Supp. 2d 1164,  
 24 1189-90 (C.D. Cal. 2007) (“It would be wholly inappropriate to permit a signatory to  
 25 evade liability because he/she did not prepare the financial report.”); *In re Zoran*  
 26 *Corp. Deriv. Litig.*, 511 F. Supp. 2d 986, 1011 (N.D. Cal. 2007) (“directors who  
 27 sign or prepare financial disclosures can be held liable for misstatements and  
 28 omissions therein”); *In re Syncor Int’l Corp. Sec. Litig.*, 327 F. Supp. 2d 1149,  
 1168 (C.D. Cal. 2004) (same; overturned on other grounds); *In re Enron Corp.*  
*Sec., Deriv. & ERISA Litig.*, 258 F. Supp. 2d 576, 587 (S.D. Tex. 2003) (citing,  
 among other cases, *Howard* for the proposition that an outside director “who on  
 behalf of the corporation signs a document that is filed with the SEC that contains  
 material misrepresentations, such as a fraudulent Form 10K, regardless of whether  
 he participated in the drafting of the document, ‘makes’ a statement and may be  
 liable as a primary violator under § 10(b)”).

1 that the Outside Directors made false statements (Ind. Defs.’ Mem. at 8-9) is  
2 inaccurate.<sup>32</sup>

3 f. **Defendants’ “Truth-On-The-Market” Defense Fails**

4 Defendants contend that they cannot be held responsible for their false  
5 statements because the true facts concerning the Company’s unsound lending  
6 practices were known to investors.<sup>33</sup> As the Ninth Circuit has explained, however,  
7 “defendants bear a heavy burden of proof” before they can succeed on a truth-on-  
8 the-market defense.<sup>34</sup> Here, Defendants’ argument fails for two primary reasons.  
9 First, Defendants’ truth-on-the-market defense is improper on a motion to dismiss  
10 because “whether adverse facts were adequately disclosed is a mixed question to  
11 be decided by the trier of fact.” *Fecht v. Price Co.*, 70 F.3d 1078, 1081 (9th Cir.  
12 1995). Accordingly, the adequacy of a disclosure can be resolved at the motion to  
13 dismiss stage only when the adequacy is “so obvious that reasonable minds  
14 [could] not differ.” *Id.*

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16  
17 <sup>32</sup> In any event, Ninth Circuit law holds: “In cases of corporate fraud where the  
18 false or misleading information is conveyed in prospectuses, registration  
19 statements, annual reports, press releases, or other ‘group-published information,’  
20 it is reasonable to presume that these are the collective actions of the officers.”  
21 *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1441-42 (9th Cir. 1987); *see also*  
22 *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018, 1031 (C.D. Cal. 2003)  
23 (same); *In re Real Estate Assoc. Ltd. P’ship Litig.*, 223 F. Supp. 2d 1142, 1149-51  
24 (C.D. Cal. 2002) (same); *In re BP Prudhoe Bay Royalty Trust Sec. Litig.*, 2007 WL  
25 3171435, at \*7 (W.D. Wash. Oct. 26, 2007) (collecting cases and explaining that  
26 the majority of courts within the Ninth Circuit have held that group pleading  
27 survives the PSLRA).

28 <sup>33</sup> *See, e.g.*, Ind. Defs.’ Mem. at 5 (“[B]ecause CFC fully disclosed the data on  
which plaintiffs base their allegations that loan loss allowances and retained  
interests were misstated (*see* App. 1), the Court cannot strongly infer that the  
Defendants deliberately refused ‘to see the obvious,’ as the market apparently did  
not see it either.”), 13 (“data from which [Plaintiffs’ allegations] are derived **was  
disclosed by CFC**” (citing App. 1) (emphasis in original)). Additionally, Appendix  
1 is factually inaccurate because it asserts that the Company’s Form 10-K for 2007  
was filed with the SEC on March 1, 2007. The Company’s 2007 Form 10-K was  
filed with the SEC on February 29, 2008, **after** the Relevant Period.

<sup>34</sup> *Provenz v. Miller*, 102 F.3d 1478, 1493 (9th Cir. 1996) (defining a “truth-on-the-  
market” defense and refusing to rule as a matter of law that investors were not  
misled by defendants’ statements).

1 Second, Defendants' argument is factually inaccurate. Contrary to  
2 Defendants' characterization, the Complaint relies on multiple sources – not just  
3 the Company's own SEC filings – to plead Defendants' securities violations.<sup>35</sup>  
4 Moreover, much of the relevant "data" disclosed by the Company was not revealed  
5 until the end of (or after) the Relevant Period. For example, prior to a  
6 November 9, 2007 exposé in *The Wall Street Journal*, the Company had not  
7 disclosed in its SEC filings the number of pay-option Adjustable Rate Mortgages  
8 ("ARMs") it originated that were no-document or low-document loans. ¶116.  
9 Such subsequent disclosures are proper to show Defendants' earlier statements  
10 were false.<sup>36</sup> As another example, Defendants misled investors as to the adequacy  
11 of the Company's allowance for loan losses by falsely claiming that pay-option  
12 ARMs were a "profitable product *that does not create disproportionate credit*  
13 *risk.*" ¶293; *see also* ¶284 (pay-option ARMs "time-tested product"). In short,  
14 Defendants did not reveal the truth in order to make their positive statements not  
15 misleading, and this forecloses application of a truth-on-the-market defense. As  
16 the Ninth Circuit has explained: "Before the 'truth-on-the-market' doctrine can be  
17 applied, the defendants must prove that the information that was withheld or  
18 misrepresented was 'transmitted to the public with a degree of intensity and  
19 credibility sufficient to effectively counterbalance any misleading impression  
20 created by insider's one-sided representations.'" *Provenz*, 102 F.3d at 1492-93  
21

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22  
23 <sup>35</sup> For example, numerous former employees revealed that the Company was  
24 secretly disregarding its underwriting standards and extending credit to un-  
25 creditworthy borrowers – which necessarily required the Company to increase its  
26 allowances for loan losses. Similarly, the Complaint cites exposés in *The Wall*  
27 *Street Journal* and *The New York Times*. *See, e.g.*, ¶¶113-17, 180. The Complaint  
28 also cites contemporaneous statements made by Defendant Mozilo indicating that  
he was aware that default rates would likely increase substantially as house prices  
declined and interest rates increased. *See, e.g.*, ¶234.

<sup>36</sup> *See, e.g., In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 73 (2d Cir. 2001)  
("[P]ost-class period data may be relevant to determining what a defendant knew  
or should have known during the class period.").

1 (citation omitted). Defendants did not do so here.<sup>37</sup>

2 2. The Complaint Raises A Strong Inference Of Scienter

3 The required state of mind is satisfied where, as here, the complaint alleges  
4 that Defendants acted either knowingly or with deliberate recklessness as to the  
5 truth of their statements. *See, e.g., Nursing Home Pension Fund, Local 144 v.*  
6 *Oracle Corp.*, 380 F.3d 1226, 1230 (9th Cir. 2004). The preceding section detailed  
7 Defendants’ false and misleading statements and omissions during the Relevant  
8 Period. Importantly, “the same basic facts that allege falsity [may] also allege  
9 scienter.”<sup>38</sup>

10 In *Tellabs*, the Supreme Court clarified the scienter pleading requirements  
11 under the PSLRA and held that courts must determine “whether *all* of the facts  
12 alleged, taken collectively, give rise to a strong inference of scienter, not whether  
13 any individual allegation, scrutinized in isolation, meets that standard.” *Tellabs,*  
14 *Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2509 (2007) (emphasis in  
15 original). Thus, contrary to Defendants’ attempts to challenge particular  
16 allegations or categories of allegations, *Tellabs* instructs that a “court’s job is not to  
17

18 <sup>37</sup> Additionally, with only one exception, Defendants concede that all of the  
19 statements they made during the Relevant Period are *not* protected by the PSLRA  
20 safe harbor. *See* Ind. Defs.’ Mem. at 15 (asserting that the safe harbor applies to  
21 only one statement in ¶288). The statement at issue reads: “We actively manage  
22 credit risk to maintain credit losses within levels that achieve our profitability and  
23 return on capital objectives while meeting our expectations for consistent financial  
24 performance.” ¶288. This is not a forward-looking statement, but a statement of  
25 then-existing fact. Either the Company was or was not actively managing its credit  
26 risk to maintain credit losses at acceptable levels. It was not. ¶¶141-74.

27 Further, even if this statement were forward-looking, identified as such, and  
28 accompanied by meaningful cautionary language – which it was not – in the Ninth  
Circuit “a person may be held liable if the ‘forward-looking statement’ is made  
with ‘actual knowledge . . . that the statement was false or misleading.’” *No. 84*  
*Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*,  
320 F.3d 920, 936 (9th Cir. 2003). Here, Defendants knew that the Company was  
deviating excessively from its underwriting standards to misleadingly inflate  
reported income. As such, the statement in ¶288 is not protected by the PSLRA  
safe harbor.

<sup>38</sup> *In re Syncor Int’l Corp. Sec. Litig.*, 239 Fed. Appx. 318, 321 (9th Cir. 2007)  
(unpubl.); *see also Ronconi v. Larkin*, 253 F.3d 423, 429 (9th Cir. 2001).

1 scrutinize each allegation in isolation but to assess all the allegations holistically,”  
2 and to determine whether the allegations “accepted as true and taken collectively,  
3 would [allow] a reasonable person [to] deem the inference of scienter at least as  
4 strong as any opposing inference.” *Id.* at 2511. In considering opposing  
5 inferences, “[t]he inference that the defendant acted with scienter need not be  
6 irrefutable . . . or even the ‘most plausible’ of competing inferences.” *Id.* at 2510.  
7 Whenever the inference of scienter is at least as compelling as any plausible  
8 opposing inference that can be drawn from the facts alleged, the motion to dismiss  
9 must be denied. *Id.* at 2509.

10 *Tellabs* instructs that the Court “must take into account plausible opposing  
11 inferences” proffered by Defendants to determine whether Plaintiffs have pleaded  
12 an inference of scienter at least as likely as any other competing inference.  
13 *Tellabs*, 127 S. Ct. at 2509. Yet, here Defendants cannot and do not explain why  
14 they were purportedly unaware of the well-pleaded fact that Countrywide  
15 abandoned its underwriting standards to increase loan volume – which is  
16 particularly compelling because senior management authorized rampant exceptions  
17 to the Company’s underwriting requirements, such exceptions were tracked by the  
18 Company’s internal computer systems, and Defendants (including the Director  
19 Defendants) were specifically tasked with monitoring compliance with these  
20 policies. Moreover, Defendants do not proffer any reasonable explanation as to  
21 why they did not increase the Company’s allowance for loan losses commensurate  
22 with the Company’s increasingly risky lending practices. Having failed to raise a  
23 reasonable opposing inference, the Court’s scienter analysis is simple. As Judge  
24 Posner observed recently on remand in *Tellabs*: “[b]ecause the alternative  
25 hypotheses [proffered by defendants] are far less likely than the hypothesis of  
26  
27  
28

1 scienter [alleged by plaintiffs], the latter hypothesis must be considered cogent.”<sup>39</sup>  
 2 Taken collectively, the allegations in the Complaint support a strong inference that  
 3 Defendants acted with scienter.

4 a. Defendants’ Insider Trading

5 A complaint need not allege insider trading or pecuniary motive to plead a  
 6 securities fraud claim successfully. *Tellabs*, 127 S. Ct. at 2511. Nevertheless,  
 7 allegations of a personal financial motive “may weigh heavily in favor of a scienter  
 8 inference.”<sup>40</sup> Here, Defendants’ egregious trading activities further eliminate any  
 9 doubt as to their scienter.

10 Between 2004 and the end of 2007, Defendants sold nearly \$850 million in  
 11 Countrywide stock. ¶¶322, 325-26. This massive amount would be significant in  
 12 any context, but is particularly suspicious here given that Defendants knew that  
 13 Countrywide’s stock price was artificially inflated during this time period as a  
 14 result of their reckless lending practices and false accounting. Defendant Mozilo,  
 15 for example, sold nearly \$475 million, Defendant Kurland sold nearly \$192  
 16 million, and Defendants Sambol and Garcia each sold over \$60 million. ¶322.  
 17 While Defendants contend that allegations of insider trading cannot contribute to  
 18 scienter absent prior trading histories, or because certain isolated sales represented  
 19

20 <sup>39</sup> *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 711 (7th Cir. 2008);  
 21 *see also In re Faro Techs. Sec. Litig.*, 534 F. Supp. 2d 1248, 1263 (M.D. Fla. 2007)  
 22 (“In spite of a direct invitation to do so, [defendants] do not provide the Court with  
 23 a ‘plausible opposing inference’ sufficient to counter the significant weight of the  
 24 scienter inference that arises from the totality of the allegations. In fact, the  
 25 absence of any suggested counter inference strengthens the contention that there  
 26 can be but one conclusion drawn from the facts, as pled.”); *In re Openwave Sys.*  
 27 *Sec. Litig.*, 528 F. Supp. 2d 236, 250 (S.D.N.Y. 2007) (in concluding that plaintiff  
 28 had sufficiently pleaded scienter under the *Tellabs* standards, explaining: “In  
 particular, a court must consider ‘plausible nonculpable explanations for the  
 defendant’s conduct.’ Defendants have not pointed to any ‘competing inferences  
 rationally drawn from the facts alleged’ that could explain their receipt of options  
 bearing dates other than the ones on which they received them.”).

<sup>40</sup> *Id.*; *see also Silicon Graphics*, 183 F.3d at 986 (insider trading is not necessary  
 to establish scienter under the PSLRA, but “unusual” or “suspicious” stock sales  
 by corporate insiders may constitute circumstantial evidence of scienter).

1 only a modest percentage of holdings,<sup>41</sup> the crucial inquiry is whether the sales are  
 2 suspicious, such that they raise a question as to a defendant's knowledge.<sup>42</sup> In  
 3 short, as the Ninth Circuit and other courts have explained, Defendants' massive  
 4 sales contribute to a strong inference of scienter.<sup>43</sup>

5 Moreover, Defendants sold stock while the Company was in the midst of a  
 6 \$2.5 billion stock repurchase program – a program instituted by Defendants.  
 7 ¶¶324-27. Defendants authorized a \$2.5 billion share repurchase program funded  
 8 largely with debt, which signaled to the market Defendants' purported belief that  
 9 the shares were undervalued. ¶324. Indeed, the Company's shares rose during the  
 10 repurchase program and arrived at an all-time high of \$45.03 on February 2, 2007.

11 *Id.* While publicly proclaiming the shares a value, however, Defendants  
 12 themselves collectively sold nearly \$150 million in stock during the quarters when  
 13 Countrywide was repurchasing stock. ¶¶325-26. Both the size and timing of  
 14 Defendants' sales are highly suspicious, as Defendants' massive stock sales at the  
 15 same time they were effectively proclaiming the shares a value create a strong

16  
 17 <sup>41</sup> Defendants apparently include unexercised options (as well as other indirectly  
 18 held common stock) in calculating stock sale percentages in an attempt to  
 19 minimize the sales. *See* Countrywide RJN, Ex. 16 n.2. In *America West*, however,  
 20 the *Ninth Circuit* derived the percentage of total holdings sold “from the common  
 21 stock and *exercised options*.” 320 F.3d at 939 n.16. However they are viewed,  
 22 Defendants' massive stock sales at opportune times are suspicious.

23 <sup>42</sup> *See, e.g., Oracle*, 380 F.3d at 1232 (finding a strong inference of scienter even  
 24 though defendant only sold 2.1% of his holdings during the class period); *In re*  
 25 *Secure Computing Corp.*, 184 F. Supp. 2d 980, 989-90 (N.D. Cal. 2001) (finding  
 26 stock sales suspicious even though “the percentage of shares sold compared to total  
 27 holdings” was not “unique and suspicious”); *Stanley v. Safeskin Corp.*, 2000 WL  
 28 33115908, at \*2 (S.D. Cal. Sept. 15, 2000) (finding strong inference of scienter  
 even though plaintiff did not allege that class period sales were out of line with  
 prior trading practices).

<sup>43</sup> *See, e.g., Oracle*, 380 F.3d at 1232 (“In the past, we have given great weight to  
 the percentage of stock sold. However, where, as here, stock sales result in a truly  
 astronomical figure, less weight should be given to the fact that they may represent  
 a small portion of the defendant's holdings.”) (citations omitted); *In re Oxford*  
*Health Plans, Inc. Sec. Litig.*, 187 F.R.D. 133, 140 (S.D.N.Y. 1999) (“The \$78  
 million profit from sales by the Individual Defendants during the Class Period is . . .  
 massive by any measure . . . . [A]llegations of unusually large insider trades at  
 suspicious times are sufficient to create, along with other allegations, a strong  
 inference of scienter.”).

1 inference of scienter.<sup>44</sup>

2 Additionally, Defendants sold stock at a greater rate during the Company's  
3 stock buyback. The two quarters when Defendants were forcing the Company to  
4 repurchase stock made up just 12.5% of the length of the Relevant Period. Yet,  
5 Mozilo sold roughly 25% of the total shares that he sold during the Relevant  
6 Period during these two quarters; over 20% of Robertson's sales occurred during  
7 the repurchase quarters; roughly 70% of Dougherty's sales occurred during these  
8 two quarters (with 100% occurring in the months between the beginning of the  
9 repurchase program and its conclusion); over 40% of Donato's sales occurred  
10 during the repurchase quarters; and roughly 20% of Cunningham's sales occurred  
11 during the repurchase quarters. ¶¶322, 325-26. Similarly, examining Defendants'  
12 average shares sold per day during the repurchase quarters compared to the  
13 average shares sold per day during the remainder of the Relevant Period, many  
14 significantly increased their average sales per day while Countrywide was  
15 repurchasing shares. For example, Mozilo increased his shares sold per day by  
16 over 60%, Robertson increased his sales by over 40%, Dougherty increased his  
17 sales per day by over 350%, Donato increased his sales per day by over 160%, and  
18 Cunningham increased his average shares per day by nearly 30%. ¶¶322, 325-26.  
19 In sum, sales "near the stock's peak" or "calculated to maximize the personal  
20 benefit from undisclosed insider information" support a strong inference of  
21 scienter. *Am. West*, 320 F.3d at 939-40.

22 Although Defendants rely heavily upon Mozilo's SEC Rule 10b5-1 plans in  
23 arguing that his sales are not suspicious, his stock sales and the plans themselves  
24

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25  
26 <sup>44</sup> See, e.g., *Am. West*, 320 F.3d at 939 (finding timing of sales suspicious where  
27 sales occurred over a three-month window when America West officials were  
28 making optimistic statements); *Terayon*, 2002 WL 989480, at \*12 (finding a strong  
inference of scienter where "defendants sold stock on the heels of the false positive  
statements when Terayon's share price was in the highest range reached during its  
history").

1 actually contribute to a strong inference of his scienter. First, Defendants contend  
2 that “all of Mr. Mozilo’s trades were pursuant to SEC Rule 10b5-1 trading plans.”  
3 Ind. Defs.’ Mem. at 7. The plan documents – only now disclosed by Defendants –  
4 and Mozilo’s SEC Form 4s not only demonstrate that this is false, but also indicate  
5 that Mozilo filed false and misleading Form 4s with the SEC. For example, the  
6 first plan provided by Defendants, entered into on April 26, 2004 and covering  
7 May 5, 2004 to May 31, 2005, provided for the sale of 75,000 shares on the first  
8 Wednesday of each month. CFC RJN, Ex. 22. Mozilo sold shares above this  
9 amount and at various points throughout May 2004 and the following months,  
10 however, and his Form 4s corresponding to these additional sales falsely indicate  
11 that the sales were pursuant to this April 26, 2004 10b5-1 plan. *See, e.g.*, RJN,  
12 Ex. 2 (Form 4 for sale of 30,000 shares on May 19, 2004, signed by Angelo  
13 Mozilo and stating in Note 1 that the “reported sale was effected pursuant to a  
14 trading plan established under Rule 10b5-1 and adopted by the reporting person on  
15 April 26, 2004”).

16 Similarly, Mozilo attempts to defuse the inference of scienter from his sales  
17 during the quarters that Countrywide was repurchasing shares by asserting that all  
18 were made pursuant to a 10b5-1 plan. During this time, however, he instituted *two*  
19 *additional plans* (on October 27, 2006 and December 12, 2006) and quickly  
20 *amended* the December 12, 2006 plan on February 2, 2007 to double the number  
21 of shares covered by the plan, all of which allowed him to sell 75% more shares  
22 during the repurchase period. *See* CFC RJN, Exs. 24-26. The entire purpose of a  
23 10b5-1 plan is for insiders to set up a regular, periodic sale of a uniform amount of  
24 shares. Mozilo’s alteration and creation of additional plans in rapid succession to  
25 take advantage of the stock repurchase plan is inconsistent with the “passive” and  
26 “pre-scheduled” purpose of a typical 10b5-1 plan and is itself highly suspicious.  
27 *See, e.g., Cent. Laborers’ Pension Fund v. Integrated Elec. Servs.*, 497 F.3d 546,  
28

1 554 (5th Cir. 2007) (observing that defendant’s “attempt to use the 10b5-1 Plan as  
2 a non-suspicious explanation is flawed because, *inter alia*, [defendant] entered into  
3 the Plan during the Class Period”; rejecting defendant’s argument premised on  
4 10b5-1 plan; and finding insider sales pursuant to plan contributed to strong  
5 inference of scienter).<sup>45</sup> The suspicious nature of Mozilo’s insider sales is  
6 confirmed by government investigations and various news articles concerning his  
7 stock sales. *See, e.g.*, ¶¶335-42.

8 Indeed, Mozilo’s actions with regard to his plans provide additional support  
9 for an inference of his scienter, as they appear to be an attempt to sell large  
10 amounts of shares while still being able to claim that the shares were “all sold  
11 pursuant to a 10b5-1 plan” during the repurchase quarters. Relatedly, the  
12 Complaint details how selling by other insiders also spiked following Mozilo’s  
13 changes to his 10b5-1 plan, a further indication of Defendants’ scienter. ¶340.  
14 Similarly, while Dougherty also contends that his shares were all sold pursuant to a  
15 10b5-1 plan, as noted, his Relevant Period sales all occurred between the  
16 beginning of the repurchase program and its conclusion, which is a strong indicator  
17 of his scienter. Dougherty also asserts that he was simply selling shares in  
18 preparation for retirement and, thus, his sales are not suspicious. *See* Dougherty  
19 Mem. at 17, 22. The Ninth Circuit has rejected this very same argument in the  
20 context of a motion for summary judgment. *Kaplan v. Rose*, 49 F.3d 1363, 1379-  
21 80 (9th Cir. 1994).<sup>46</sup> The question of whether retirement was the motivation for a  
22

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23 <sup>45</sup> *See also* 17 C.F.R. § 240.10b5-1(c)(A)(1) (A trading plan only provides an  
24 affirmative defense if entered into “[b]efore becoming aware of the information.”).

25 <sup>46</sup> In *Kaplan*, the Ninth Circuit explained that the defendant’s sales “were in large  
26 amounts and at sensitive times,” and the argument that a defendant “wanted to reap  
27 financial benefits for personal reasons - merely beg[s] the question of whether [he]  
acted on the basis of undisclosed inside information in order to reap large returns.”  
49 F.3d at 1380. Accordingly, the Ninth Circuit concluded that evidence of the  
stock sales was sufficient to create a genuine issue of material fact:

28 [If defendant’s] motivation in selling his stock was to fund retirement  
activities, plaintiff would doubtless argue that the desire to sell the

1 defendant's stock sales is even more inappropriate for resolution on a motion to  
2 dismiss.<sup>47</sup>

3 **b. Defendants' Contemporaneous Knowledge Of**  
4 **Information Contradicting Their Public Statements**

5 "A strong inference of scienter exists when there are allegations that a  
6 defendant 'knew facts or had access to information suggesting that [the  
7 company's] public statements were not accurate.'"<sup>48</sup> Thus, "securities fraud claims  
8 typically have sufficed to state a claim based on recklessness when they have  
9 specifically alleged defendants' knowledge of facts or access to information  
10 contradicting their public statements." *Novak v. Kasaks*, 216 F.3d 300, 308 (2d  
11 Cir. 2000).

12 Here, Defendants had access to facts clearly indicating that their public  
13 statements were false. Defendants repeatedly represented to the public that they  
14 actively monitored Countrywide's underwriting practices, credit risk, allowance  
15 for loan losses, valuations of retained interests, hedging activities, access to  
16 liquidity, and financial reporting. And, according to the CWs, information  
17 concerning the truth was readily available to, and reviewed by, Defendants.

18 stock to fund retirement was an incentive for [the defendant] to cause  
19 the making of inflationary misstatements. Such an implication would  
20 give substance to the contention that the alleged misrepresentations  
and omissions were deliberate.

21 *Id.* (quoting *Goldman v. Belden*, 754 F.2d 1059, 1071 (2d Cir. 1985)).

22 <sup>47</sup> *Goldman*, 754 F.2d at 1071. Relatedly, to the extent any Defendant suggests  
23 that his insider sales were simply a move to "diversify" holdings, the Ninth Circuit  
has explained that this similarly provides no basis for dismissal. *See, e.g., Am.*  
*West*, 320 F.3d at 941 ("Although it is possible that the controlling shareholders  
were trying to limit their equity exposure . . . this is a question for the jury, or at  
least one that should be explored during discovery.").

24 <sup>48</sup> *In re Converium Holding AG Sec. Litig.*, 2007 WL 2684069, at \*1-2 (S.D.N.Y.  
25 Sept. 14, 2007) (applying *Tellabs* and denying motion to dismiss where the "thrust  
of the complaint is that the defendants hid from investors that Converium's loss  
26 reserves were hundreds of millions of dollars less than they needed to be"); *see*  
*also Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 665 (8th Cir.  
27 2001) ("One of the classic fact patterns giving rise to a strong inference of scienter  
is that defendants published statements when they knew facts or had access to  
28 information suggesting that their public statements were materially inaccurate."  
(collecting cases)).

1 Taking these statements as true as the Court must, Defendants were aware, or were  
2 reckless in not being aware, of the true facts making their public statements  
3 misleading. Moreover, as members of the Board Committees described in the  
4 Complaint, the Director Defendants were directly responsible for overseeing these  
5 very same issues. CWs and internal Company reports and documents confirm that  
6 Defendants knew the true facts at the same time that they made their false and  
7 misleading statements.

8 (1) Defendants Admit That They  
9 Were Monitoring The Relevant Issues

10 Defendants repeatedly represented to the public that they were monitoring  
11 the Company's adherence to its underwriting standards, default rates, setting of  
12 reserves, valuation of assets held for investment, and hedging activities. In short,  
13 as the Company's assigned lead independent director, Defendant Snyder, was  
14 quoted in *The Wall Street Journal* in November 2007, the Board has been actively  
15 "engaged in every significant issue facing the company." ¶132. Moreover, as a  
16 Countrywide spokesperson was quoted in *The New York Times* in November 2007:  
17 "Countrywide's board of directors has always been actively engaged in overseeing  
18 the company's senior management and business strategy." *Id.*

19 More specifically, with regard to underwriting and adherence to  
20 underwriting standards, the Company's Form 10-Ks, which were signed by each  
21 member of the Board and Defendant Sieracki, explained that the Company used  
22 extensive internal controls and computer software, including proprietary  
23 technology, to monitor underwriting compliance both before and after funding.  
24 ¶¶135, 146. As at least one recent decision has concluded, sophisticated  
25 monitoring systems for tracking adherence to origination standards contribute to an  
26 inference of scienter. *See Accredited*, 2008 WL 80949, at \*10. This is particularly  
27 true here, where Defendants repeatedly boasted that Countrywide's loan  
28 origination practices and underwriting were more conservative than those of its

1 competitors, such as Accredited. *See, e.g.*, ¶¶144-46. Defendants cannot now  
2 disclaim any knowledge as to the Company’s failure to adhere to underwriting  
3 standards during the Relevant Period.

4 The Company similarly emphasized that management “actively monitor[ed]  
5 the delinquency and default experience . . . by considering current economic and  
6 market conditions.” ¶204. Moreover, the Company’s Form 10-Ks stated that  
7 senior management (*i.e.*, Defendants Mozilo and Sambol) were “actively involved  
8 in the review and approval of our allowance for loan losses.” *Id.* And, as the  
9 Company’s Form 10-K for 2006 explained: “We continually assess the credit  
10 quality of our portfolios of loans held for investment to identify and provide for  
11 losses incurred.” ¶205. With regard to valuing mortgage servicing rights and  
12 retained interests, the Company reported that “senior financial management  
13 exercises extensive and active oversight of this process.” ¶211. Similarly, the  
14 Company’s public filings emphasized that it closely monitored hedging activities,  
15 noting that it actively managed hedging risks “on a daily basis.” ¶215.<sup>49</sup>

16 Defendants’ repeated statements that they (especially Mozilo and Sambol)  
17 closely monitored the very issues central to the false statements detailed above  
18 provide strong circumstantial evidence that they had contemporaneous knowledge  
19 of facts contrary to their false statements.

20 (2) Defendants Were Charged With Monitoring  
21 The Issues Central To Their False Statements

22 In addition to their public statements, as discussed above, the Director  
23 Defendants had specific oversight duties with respect to the alleged fraud. *See*  
24 § II.A.2.; ¶¶75-97 (detailing Board Committee membership and highlighting duties  
25 of each Committee). Moreover, each of the Committees was tasked with

26  
27 <sup>49</sup> The Company’s Form 10-K for 2006 stated that the Company “formally  
28 assesses, both at the inception of the hedge and on an ongoing basis, whether the  
derivative instruments used are highly effective in offsetting changes in fair values  
or cash flows of hedged items.” ¶214.

1 “mak[ing] recommendations to the [entire] Board” related to each one’s specific  
2 responsibilities. *See, e.g.*, ¶¶88, 92.

3 As to the Individual Defendants who were not directors, they were high  
4 ranking officers in charge of Countrywide’s core business operations, and these  
5 issues are of central importance to Countrywide’s business. In sum, Defendants  
6 not only represented to the public that they monitored these areas that are crucial to  
7 Countrywide’s business, but they were specifically charged with overseeing these  
8 same policies, practices, and financial measures. Accordingly, there is a strong  
9 inference that, at the time they issued the false and misleading statements,  
10 Defendants knew information contrary to those public statements.

11 (3) Defendants’ Knowledge Of Information  
12 Contrary To Their Public Statements

13 Despite riskier lending and investment practices – including abandonment of  
14 underwriting standards – and the ramifications of an impending slowdown in the  
15 housing market and rising interest rates, and knowing that the Company’s  
16 delinquency rates were growing rapidly each quarter, Defendants maintained  
17 Countrywide’s allowance for loan losses at their historic levels far below industry  
18 standards. Faced with the facts known to Defendants, their failure to increase the  
19 allowance provides strong support for an inference of scienter. *See, e.g.,*  
20 *Accredited*, 2008 WL 80949, at \*10. CWs and internal documents confirm  
21 Defendants’ knowledge or recklessness as to the truth, and the Complaint  
22 successfully pleads Defendants’ scienter.

23 (a) Defendants Knew That Countrywide Had  
24 Shifted To Riskier Lending And Had  
25 Disregarded Underwriting Standards

26 Defendants knew that, beginning in 2003, the Company shifted its strategy  
27 to non-traditional, risky lending, which increased the Company’s exposure in the  
28 event of a housing downturn, increase in interest rates, or credit issues. ¶¶107-40.  
Between 2002 and 2005, Countrywide drastically increased its origination of

1 riskier “non-conforming” loans – loans that could not be sold to government  
2 sponsored entities (like Fannie Mae) but had to be sold to private institutional  
3 investors. ¶108. While these loans made up just 24.9% of Countrywide’s lending  
4 in 2002, by 2005 they comprised 47.2% of originations, nearly double the  
5 percentage from just three years earlier. *Id.* Moreover, Defendants knew, or were  
6 reckless in not knowing, that Countrywide began to focus its lending on a wide  
7 range of “non-traditional” and high risk home loans – a dramatic shift in direction  
8 away from traditional, fixed rate lending. ¶¶109, 112. For example, while  
9 adjustable rate mortgages made up just 14% of originations in 2002, by 2005 these  
10 loans made up 52% of Countrywide’s loan originations – 3.7 times the percentage  
11 from two years earlier. ¶¶111-12. Similarly, the Company rapidly increased its  
12 origination of HELOCs during the same time frame. *Id.* Countrywide reported  
13 that its percentage of non-prime originations in 2004, 2005, and 2006 were more  
14 than double the percentage of non-prime originations in 2002. *Id.* (3.7% in 2002  
15 and 10.9% in 2004).

16 Defendants knew that Countrywide jumped into the pay-option ARM  
17 business in 2003, quickly becoming a leader in this especially risky loan product,  
18 which not only allowed borrowers to pay down no principal, but permitted  
19 borrowers to make a payment that did not even cover the monthly interest. ¶¶110  
20 (description of pay-option ARMs), 120 (explaining risky nature of pay-option  
21 ARMs). Countrywide did not even offer these loans until 2003, but by 2005 the  
22 Company originated \$93 billion of pay-option ARMs, 19% of its originations.  
23 ¶¶112, 115. In the Fall of 2007, an analysis conducted by UBS AG for *The Wall*  
24 *Street Journal* revealed that the Company had managed such a dramatic increase in  
25 its production of these loans by “giving these loans to riskier and riskier  
26 borrowers.” ¶115. In 2004, 78% of these loans were “low doc” mortgages in  
27 which the borrowers did not fully document their income, and by 2006, 91% of  
28

1 Countrywide's pay-option ARMs went to borrowers who were not fully  
2 documenting their income. ¶116. Such low documentation loans are inherently  
3 more risky. *See, e.g.*, ¶126. Further increasing the risk, Countrywide increased its  
4 originations of pay-option ARMs to borrowers who were putting little money  
5 down. ¶117. By 2006, nearly 29% of Countrywide's pay option ARMs had loan  
6 to value ratio of 90% or more. *Id.*

7 Defendants knew that these non-traditional loans posed substantially more  
8 risk than traditional fixed rate loans. As *The Wall Street Journal* noted in a report  
9 on Countrywide, and as Defendants knew all along, HELOCs are "high risk"  
10 because they are "potentially worthless in a default because the first-lien holder  
11 gets first dibs on the home." ¶119. If home prices declined, the collateral  
12 supporting Countrywide's HELOCs would disappear first. *Id.* Similarly, as  
13 Countrywide reported, and as Defendants knew, pay-option ARMs were especially  
14 risky: "Due to pay-option ARM loans' amortization characteristics, the loss that  
15 the Company would realize in the event of default may be higher than that realized  
16 on a 'traditional' loan that does not provide for a deferral of a portion of the fully  
17 amortizing loan payment." ¶124.

18 Not only was the Company engaged in riskier and riskier lending activities  
19 necessitating stronger underwriting standards, but Defendants knew, or were  
20 reckless in not knowing, that the Company was disregarding its underwriting  
21 standards to increase loan volume, capture more market share, and report inflated  
22 income levels – *all of which was kept from the public*. The Complaint contains  
23 the accounts of numerous Countrywide employees from across the country  
24 detailing how the Company disregarded its underwriting standards to originate  
25 more loans. ¶¶147-74. These accounts are reliable, and as the Ninth Circuit has  
26 observed, witness accounts from various offices throughout the country of a large  
27  
28

1 corporation can provide strong support for defendants' scienter.<sup>50</sup> The witnesses  
 2 provide consistent accounts of the practices occurring throughout Countrywide.  
 3 Further, reports and internal documents described by various sources confirm that  
 4 the Company disregarded underwriting standards to increase loan volume.<sup>51</sup>

5 For example, CW1, a former Underwriter II from a Jacksonville, Florida  
 6 processing center, detailed how as many as 80% of the loans originated involved  
 7 significant variations from underwriting standards requiring a management sign  
 8 off, and how management pushed underwriters to approve as many loans as  
 9 possible. ¶147(a). When a loan was declined, it would "come back to life" when  
 10 new information appeared. *Id.* Similarly, CW2, a senior underwriter from  
 11 Roseville, California, and CW9, a compliance auditor in Countrywide's Capital  
 12 Markets, Plano, Texas facility, detailed how Countrywide would label loans as  
 13 "prime" even if made to unqualified borrowers, including those who had recently  
 14 gone through bankruptcy or whose income was clearly excessive for a given  
 15 occupation. ¶¶147(b), 156-57. Another former Countrywide loan processor from  
 16 Anchorage, Alaska, CW4, explained that branch managers pushed low or no-  
 17 documentation loans because they could be processed without paperwork, and  
 18 CW4 confirmed that borrowers were often approved for loans based on patently  
 19 ridiculous stated incomes, including a cab driver who claimed to earn \$13,000 per  
 20 month. ¶147(d). Likewise, CW6, an external home loan consultant who was  
 21 responsible for originating prime loans for the residential market, CW7, a senior  
 22

23  
 24 <sup>50</sup> *Oracle*, 380 F.3d at 1231 (even though half of the business occurred outside of  
 25 the United States and the plaintiffs' witnesses were located in the United States,  
 26 finding: "Plaintiffs' witnesses' evaluations of Oracle's financial health in the  
 27 United States thus offer a substantial window into the overall financial health of  
 28 the corporation. In combination with the remaining allegations in the Complaint,  
 these statements create a strong inference of scienter.").

<sup>51</sup> *See, e.g.*, ¶¶166, 168, 180. Additionally, as described above, the Company's  
 quality control department performed "comprehensive loan audits" employed  
 "post-funding proprietary loan performance evaluation system," and evaluated and  
 measured adherence to underwriting standards. ¶135.

1 loan officer from Atlanta, Georgia, and CW8, a compliance auditor who worked in  
2 both Georgia and Texas, all confirmed that the no-documentation loan process  
3 lacked independent verification of income and was openly abused. ¶154. Other  
4 employees similarly explained the disregard for underwriting, stating that getting  
5 the loan done and making numbers were the overriding concerns. ¶¶148; 159-60.

6 CW10, a former Executive Vice President of Production Operations and  
7 later Executive Vice President of Process Improvement, explained that Defendant  
8 Sambol and senior management clearly knew about the Company's rampant  
9 deviations from its underwriting policies and endorsed the conduct. ¶¶162, 167-

10 68. CW10, who worked at Countrywide for 17 years until the Fall of 2005,  
11 worked with Defendant Sambol in 2005 to create a computer system, the  
12 Exception Processing System, that routed highly risky loans out of the normal loan  
13 approval process and to a central underwriting group in Plano, Texas. ¶¶162-63.

14 While the Exception Processing System identified loans that violated the  
15 underwriting standards, these loans were not rejected. ¶164. Instead, Defendant

16 Sambol wanted the underwriting group to review these loans to see whether these  
17 loans should require a higher price or higher interest rate in light of the violation.

18 *Id.* Central underwriting entered information into the system about its decision to  
19 approve these loans and charge additional fees to the borrower. *Id.* Confirming  
20 the other witnesses' accounts, CW10 explained that senior management did not  
21 want to turn down loans, and CW10 stated that loans that did not meet  
22 Countrywide's underwriting standards were approved and funded routinely. ¶165.  
23 According to CW10, the data in the Exception Processing System was available to  
24 top executives either online or through system-generated reports, and Defendant  
25 Sambol had access to the Exception Processing System and could view the  
26 information at any time. ¶166.

27 Additionally, CW10 explained that the Chief Risk Officer's department  
28

1 generated numerous other reports detailing various factors measuring the  
2 performance of Countrywide's loans, adherence to underwriting standards, and  
3 similar issues. ¶168. CW10 stated that he reviewed and discussed these reports  
4 with former Chief Risk Officer John McMurray, and numerous Company  
5 executives received copies of reports issued by this department at least monthly.

6 *Id.* Additionally, CW10 explained that the Investor Accounting Department in  
7 Simi Valley, California, did virtually nothing but generate reports. *Id.*

8 An exposé by *The New York Times* in August 2007 detailed some of  
9 Countrywide's more egregious lending activities and corroborated the accounts of  
10 the CWs that the Company had abandoned its underwriting standards. ¶180. In  
11 the article, *The New York Times* explained:

12 Countrywide's entire operation, from its computer system to its  
13 incentive pay structure and financing arrangements, is intended to  
14 wring maximum profits out of the mortgage lending boom no matter  
15 what it costs borrowers, according to interviews with former  
16 employees and brokers who worked in different units of the company  
17 and internal documents they provided.

18 *Id.* Citing additional internal documents, the article stated that "documents from  
19 the subprime unit also show that Countrywide was willing to underwrite loans that  
20 left little disposable income for borrowers' food, clothing and other living  
21 expenses." ¶181. Further corroborating the witnesses' accounts, analysts have  
22 indicated that many of the loans labeled as "prime" by Countrywide have been  
23 performing in line with other lenders' subprime lendings. ¶250.

24 Finally, Countrywide's disregard for its underwriting standards, which in  
25 some cases has led to violations of the law, has resulted in numerous governmental  
26 investigations and a 2006 agreement with the attorney general of New York to  
27 compensate certain borrowers. ¶185. Defendants were clearly aware of these legal  
28

1 actions and settlements given that they involved Countrywide's core business  
2 operations – its lending practices. *See, e.g., Am. West*, 320 F.3d at 943 n.21  
3 (finding it “patently incredible” and “absurd to suggest that the Board of Directors”  
4 would not be aware of investigations and a potential penalty related to America  
5 West's core business operations).

6 In short, the witness accounts, internal documents, and various reports and  
7 investigations confirm that Countrywide was originating loans in violation of its  
8 underwriting standards and that Defendants had specific evidence of this practice,  
9 which Defendants never revealed to the public.

10 (b) Defendants Knew That Countrywide Was  
11 Increasing Its Holdings In Risky Loans

12 Defendants also knew that, not only was Countrywide originating more and  
13 more of the riskiest types of loans and disregarding its underwriting standards as to  
14 those loans, but the Company was holding more and more of these risky loans for  
15 investment. For example, by the end of 2006, the Company held a staggering  
16 \$32.7 billion of pay-option ARMs for investment. ¶118. Moreover, as Defendants  
17 knew throughout the Relevant Period, but which the Company only reported in late  
18 Fall of 2007, by the end of 2006 81% of the pay-option ARMs held for investment  
19 contained low or no documentation of income. ¶116. Overall, pay-option ARMs  
20 and HELOCs made up over half of Countrywide's portfolio of loans held for  
21 investment as of December 2006. This increased to 74% by October of 2007.  
22 ¶264.

23 In addition to holding large amounts of its riskiest loans for investment,  
24 Defendants also knew that the Company retained large interests in the riskiest  
25 loans that it was originating and securitizing. Countrywide retained interests in  
26 these securitizations as a form of credit enhancement, as these retained interests  
27 would take the first losses if a mortgage pool underperformed. ¶¶127-30. In sum,  
28 Defendants knew, or were reckless in not knowing, that the Company was holding

1 a portfolio of extremely risky loans and retained interests, and they knew that  
2 many of the underlying loans were originated in violation of Countrywide's  
3 underwriting policies, making the investments even riskier. Yet, despite the  
4 increased risk, Defendants did nothing to increase the Company's allowance for  
5 loan losses or to value its retained interests appropriately.

6 (c) Defendants Knew That  
7 Countrywide's Hedging Was Ineffective

8 Countrywide maintained "hedges" on its retained interests, mortgage  
9 servicing rights, and loans held for sale, as changes in the valuations of these assets  
10 would directly affect the Company's earnings. See ¶¶210-30. The Company's  
11 Form 10-Ks indicated that senior management closely monitored the effectiveness  
12 of the hedges and actively managed risks "on a daily basis." ¶¶214-15.  
13 Defendants knew, however, that these hedges were not effective. See ¶¶212, 218-  
14 19 (charts demonstrating ineffectiveness of hedges). From the third quarter of  
15 2006 to the fourth quarter of 2007, while the change in valuation of the Company's  
16 mortgage servicing rights and retained interests should have roughly cancelled  
17 each other out, the Company lost approximately \$2.6 billion in earnings. ¶218.

18 Defendants were told that the hedges were ineffective before the Company  
19 suffered its hedging related losses. CW11, a First Vice President and Director in  
20 Countrywide's Capital Markets Accounting Department from 1998 until January  
21 2007, explained that the Company's hedges were clearly not effective as early as  
22 2006. ¶¶221-22. CW11 stated that his monthly findings from September to  
23 December 2006 were reported to Countrywide's CFO, and he believes that his  
24 findings also would have been reported to Defendant Mozilo. ¶228. Further, the  
25 Company's internal auditors purportedly conducted an internal investigation. *Id.*  
26 No such investigation could have been conducted with regard to such an important  
27 accounting metric without the Audit Committee's knowledge, and no investigation  
28 could have legitimately concluded that the Company's hedges were effective.

(d) Defendants Knew Various Facts Demonstrating That Increasing Numbers Of Borrowers Were In Danger Of Defaulting

Defendants knew at the time that they had no rational basis to maintain the allowance for loan losses at historic levels or to maintain the same valuation methodology on Countrywide's retained interests.

First, as Defendants knew, and as the Company reported, the percentage of delinquencies in the Company's pay-option ARMs held for investment had increased ten-fold from 2004 to the beginning of 2007, and the delinquency percentage in its HELOCs had increased more than four times. ¶198.

Second, Defendants knew that the majority of the Company's pay-option ARM borrowers were not even making full interest payments. For the nine months ended September 30, 2006, two-thirds of pay-option ARM borrowers were making less than the full interest payment. ¶¶201-202. Rather than increase the allowance for loan losses, however, the Company simply recorded massive amounts of negative amortization from these loans. The amount of accumulated negative amortization recorded by Countrywide increased from \$29,000 in 2004 to over \$815 million in 2006 and continues to rise – an obvious indicator that more and more borrowers are in trouble. ¶201. Moreover, Mozilo demonstrated his knowledge of the impending problems in 2006, when he publicly acknowledged that the majority of borrowers on the pay-option ARMS were only making minimum payments, and that this posed a significant problem of defaults once the housing market declined. ¶203. As a Merrill Lynch economist described, and as Defendants knew or were reckless in not knowing, pay-option ARMS were “ticking time bombs.” ¶199.

Third, Defendants knew that interest rates were rising, ¶239, and that this would have a particularly drastic effect on Countrywide's loans held for investment, because such a large percentage were adjustable rate. Further, the

1 Company explained in its 2006 Form 10-K that rising interest rates would similarly  
2 affect its retained interests, mortgage servicing rights, and hedging activities. *See*,  
3 *e.g.*, ¶216.

4 Finally, as Defendants knew, and as the Company stated in its SEC filings,  
5 housing price declines combined with rising interest rates would affect borrowers'  
6 ability to repay their loans, ¶¶233, 235, and they knew that the effect would be  
7 even more pronounced for Countrywide, given the Company's emphasis on  
8 adjustable rate loans and loans requiring little, if any, down payment. Defendants  
9 knew no later than the beginning of 2006 that the overheated housing market was  
10 poised to decline. ¶234. Indeed, in February or March of 2006, Defendant Mozilo  
11 publicly stated that he expected substantial declines in home values in the near  
12 future:

13 I would expect a general decline of 5% to 10% throughout the  
14 country, some areas 20%. And in areas where you have had heavy  
15 speculation, you could have 30%. We will see . . . sellers back off  
16 from the prices they have been demanding. A year or a year and half  
17 from now, you will have seen a slow deterioration of home values and  
18 a substantial deterioration in those areas where there has been  
19 speculative excess.

20 *Id.* In sum, Defendants knew, or were reckless in not knowing, of the serious and  
21 increasing distress in its loan portfolio.

22 (e) Defendants Knew That The Company's  
23 Accounting Was "Critical" To Representing  
Fairly Countrywide's Financial Condition

24 The Company's Form 10-Ks, signed by the Director Defendants and  
25 Defendant Sieracki, repeatedly stated that the computation of the allowance for  
26 loan losses, valuation of mortgage servicing rights and retained interests, and  
27 interest rate management activities were "critical" to the presentation of the  
28

1 Company's financial condition. See ¶133; RJN, Ex. 1. Yet, despite knowing that  
2 its loan portfolio was at higher risk, Defendants failed to increase the Company's  
3 allowance for loan losses and failed to take appropriate impairments of its retained  
4 interests, which made Countrywide appear more profitable than it really was. The  
5 failure to adjust the allowance for loan losses "[i]n light of Defendants' alleged  
6 awareness that the company had begun to deviate from its own underwriting  
7 policies and that the quality of the company's loan portfolio would begin to  
8 decrease" supports an inference of scienter. *Accredited*, 2008 WL 80949, at \*10.

9 For instance, from 2002 to 2003, when Countrywide's shift to riskier lending  
10 began in earnest and when, correspondingly, it should have begun increasing its  
11 allowance for loan losses, the Company actually slashed its allowance for loan  
12 losses (as a percentage of loans held for investment) by more than half. ¶194  
13 (decreased from .69% to .30%). Moreover, despite the increasingly risky character  
14 of its loan portfolio and abandonment of underwriting standards over the next  
15 several years, Defendants kept the allowance for loan losses at this same depressed  
16 level until 2007. *Id.* Not only did they keep the allowance at a constant level,  
17 Countrywide's allowance for loan losses was significantly lower than that of its  
18 peers during this time, suggesting that its portfolio was considerably less risky,  
19 which it was not. See ¶206 (Countrywide's allowance for loan losses roughly half  
20 that of Washington Mutual, roughly one-half to one-quarter that of Wachovia  
21 Bank, and roughly one-third to one-quarter that of FirstFed Financial).

22 As confirmed by Defendants' Appendix 2, not until 2007 did they begin to  
23 increase the allowance for loan losses. ¶194; App. 2 (Per quarter in 2007,  
24 increasing allowance for loan losses as follows: .50, .69, 1.44, and 2.39%). While  
25 Defendants apparently attempt to disclaim any responsibility due to the fact that  
26 they began increasing the allowance for loan losses in 2007, their actions were too  
27 late – Defendants knew far earlier that the allowance was inadequate – and the  
28

1 increases were much too modest. Only beginning in the third quarter of 2007 did  
2 Defendants increase the allowance for loan losses to a level greater than that in  
3 2002, when Countrywide’s lending practices were far less risky. App. 2; ¶194. By  
4 the end of 2007, Countrywide was forced to increase its allowance for loan losses  
5 to \$1.84 billion, an increase of over 700% versus the \$261 million at the end of  
6 2006. ¶197.

7 Similarly, and for the same reasons, Defendants knew that they had caused  
8 Countrywide to overstate the value of its retained interests during this time. As  
9 explained, these retained interests were in the “first loss” position on  
10 Countrywide’s riskiest loans, and Defendants knew of the various problems in  
11 these portfolios long before taking appropriate impairments to the value at which  
12 Countrywide carried these assets. As one example, at the end of the first quarter of  
13 2007, Countrywide carried its retained interests in HELOCs at approximately \$1.4  
14 billion. ¶209. By the next quarter, however, Countrywide began slashing the  
15 value of these assets – reducing it by nearly \$400 million – and it continued cutting  
16 the value in the following quarters. *Id.*

17 Moreover, contrary to Defendants’ reliance on audit opinions, the Court  
18 must reject the argument that “an unchallenged audit opinion by [the Company’s  
19 auditor] undercuts Lead Plaintiffs’ claim that loss reserves were deficient” because  
20 “at this stage of the litigation, a court may not ‘weigh the evidence that might be  
21 presented at trial.’” *Converium*, 2007 WL 2689069, at \*3.<sup>52</sup>

22 c. The GAAP Violations And Violations Of Company  
23 Policy Support A Strong Inference Of Scienter

24 In violation of GAAP, Countrywide manipulated its earnings by failing to

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25 <sup>52</sup> See also *Middlesex*, 527 F. Supp. 2d at 1190 (“The fact that the financial  
26 statements were audited is insufficient to negate a finding of knowledge or  
27 deliberate recklessness on the part of Defendants.”); *Marksman Partners, L.P. v.*  
28 *Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1314 (C.D. Cal. 1996) (“The fact that  
Chantal’s independent auditor may have approved the accounting methods will not  
shield Chantal from liability for deception such methods may have caused.”).

1 take appropriate allowances for loan losses and by overstating the value of its loan  
 2 assets. Indeed, when Defendants belatedly began to alter these figures, it had a  
 3 direct and massive effect on Countrywide's profitability. *See, e.g.*, ¶¶197  
 4 (increasing allowance for loan losses by over \$1.5 billion or 700%), 209 (slashing  
 5 value of retained interests by \$400 million). Such serious GAAP violations  
 6 provide circumstantial evidence of scienter. *See, e.g., Daou*, 411 F.3d at 1022  
 7 ("significant violations of GAAP standards can provide evidence of scienter");  
 8 *Accredited*, 2008 WL 80949, at \*10 ("The sizable impact on Accredited's reported  
 9 earnings of these alleged violations of GAAP [failure to increase reserve accounts  
 10 when faced with alleged knowledge that portfolio quality would decrease] also  
 11 supports an inference of scienter.").<sup>53</sup> While Defendants contend that GAAP  
 12 violations alone are not sufficient to establish a strong inference of scienter,  
 13 Plaintiffs do not rely on the GAAP violations alone.

14 In addition to the GAAP violations, "[c]ourts have held that violation of a  
 15 company's own policy supports an inference of scienter."<sup>54</sup> Here, Defendants  
 16 allowed Countrywide to violate numerous internal policies relating to valuation,  
 17

18 <sup>53</sup> The need to increase the allowances for loan losses under these circumstances  
 19 was far from a complicated accounting issue, and it was the only rational reaction.  
 20 Further, regardless of the complexity of accounting issues, "whether they were  
 21 handled within the parameters of good faith decision-making or whether the  
 22 decisions amounted to recklessness will surely be the focus of any trial." *Green*  
 23 *Tree*, 270 F.3d at 666. Accordingly, courts should "not prejudge that issue," and  
 24 "must assume the truth of the allegations pleaded with particularity in the  
 25 complaint. The strong-inference pleading standard does not license us to resolve  
 26 disputed facts at this stage of the case." *Id.* Here, as the severity of Countrywide's  
 27 GAAP violations related to allowance for loan losses and retained interests are  
 28 being revealed, "[t]he more serious the error, the less believable are [corporate]  
 defendants['] protests that they were completely unaware of [the corporation's]  
 true financial status and the stronger is the inference that defendants must have  
 known about the discrepancy." *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246,  
 1256 (N.D. Ill. 1997).

<sup>54</sup> *Chalverus v. Pegasystems, Inc.*, 59 F. Supp. 2d 226, 235 (D. Mass. 1999) (citing  
*Provenz*, 102 F.3d at 1490); *see also Adaptive Broadband*, 2002 WL 989478, at \*1  
 (strong inference of scienter supported where defendant "overrode accounting  
 methods and internal company policies to extend credit to customers with  
 questionable credit histories").

1 risk management, financial reporting, and underwriting. As just one example,  
2 under Defendants' watch, the Company completely abandoned its underwriting  
3 guidelines, allowing the Company to originate as many loans as possible, and  
4 inviting numerous governmental investigations. Knowingly allowing the  
5 Company to violate its underwriting practices in such widespread ways contributes  
6 to a strong inference of Defendants' scienter.

7 d. Defendants' False Statements About Core Business  
8 Operations Support A Strong Inference Of Scienter

9 Defendants' false statements all related to Countrywide's core business  
10 operations, which further contribute to a strong inference of scienter. Numerous  
11 courts have held that facts critical to a business' core operations or important  
12 transactions generally are so apparent that their knowledge may be reasonably  
13 attributed to the company and its officers and directors.<sup>55</sup>

14 *America West* is particularly instructive, as the Ninth Circuit held that  
15 members of America West's board were deemed to have knowledge of the  
16 company's maintenance issues and communications with the FAA. 320 F.3d at  
17 942-43. Moreover, the Ninth Circuit found "patently incredible" defendants'  
18 arguments that "issues regarding maintenance, safety, and the FAA investigation  
19 and settlement were 'purely [] management issue[s] that never rose to the level of  
20 Board discussions or communications with any shareholders'" *Id.* at 943 n.21  
21 (quoting defendants' brief). As the court explained, "[i]t is absurd to suggest that  
22 the Board of Directors would not discuss either the repurchasing authorization for  
23 millions of dollars worth of stock or the FAA investigations or negotiations,

24 \_\_\_\_\_  
25 <sup>55</sup> See, e.g., *Am. West*, 320 F.3d at 942-43 and n.21; *South Ferry LP #2 v.*  
26 *Killinger*, 399 F. Supp. 2d 1121, 1139 (W.D. Wash. 2005) ("However, where  
27 allegations of actual knowledge are not necessary, 'it may be inferred that facts  
28 critical to a business's core operations or an important transaction are known to a  
company's key officers.'"); *In re Tel-Save Sec. Litig.*, 1999 WL 999427, at \*5  
(E.D. Pa. Oct. 19, 1999) ("Knowledge concerning a company's key businesses or  
transactions may be attributable to the company, its officers and directors.").

1 especially considering the fact that the FAA had indicated that it was considering  
 2 penalties of up to \$11 million.” *Id.* Likewise, here the Director Defendants were  
 3 tasked with monitoring the issues central to their false statements, they stated that  
 4 they monitored these issues, and it is “patently incredible” that they were not aware  
 5 of the facts contradicting their false statements regarding Countrywide’s core  
 6 business operations. Similarly, Countrywide’s officers were charged with  
 7 overseeing Countrywide’s core business operations, they stated that they were  
 8 monitoring these issues, and their claims of ignorance must fail.

9 e. Defendants’ Signatures On SEC Filings  
 10 Contribute To A Strong Inference Of Scienter

11 Mozilo and Sieracki’s signed certifications pursuant to the Sarbanes-Oxley  
 12 Act (“SOX”) further support a strong inference of scienter. *See, e.g.*, Complaint,  
 13 Ex. 1. As the CEO and CFO, pursuant to SOX § 302, they each attested that  
 14 adequate control procedures were in place and functioning throughout the Relevant  
 15 Period. *Id.* They also certified that they had reviewed Countrywide’s Forms 10-Q  
 16 and 10-K for those periods, and that, based on their knowledge, none of the  
 17 information presented in the reports was false or misleading. *Id.* SOX further  
 18 required them to certify that they were each responsible for establishing and  
 19 maintaining Countrywide’s disclosure “controls and procedures . . . and internal  
 20 control over financial reporting.” *Id.*<sup>56</sup> Therefore, either both had actual

21 \_\_\_\_\_  
 22 <sup>56</sup> SOX § 302’s certification requirements were expressly designed to prevent top  
 23 executives from adopting a “head in the sand” defense to securities fraud  
 24 committed on their watch. Thus, numerous courts have rejected the argument that  
 25 SOX certifications do not contribute to an inference of scienter. As a court in this  
 26 district recently explained:

27 For these certifications to have any substance, signatories to the  
 28 certifications must be held accountable for the statements. *See*  
*Howard v. Everex*, 228 F.3d 1057, 1061 (9th Cir. 2000). It would be  
 wholly inappropriate to permit a signatory to evade liability because  
 he/she did not prepare the financial report, as Defendants argue, on  
 the ground that the signatory was unaware of the misstatements made  
 therein. To hold otherwise would effectively eviscerate the entire  
 substance of 18 U.S.C. § 1350, the purpose of which is to ensure that

1 knowledge of the fraud and allowed it, or they were severely reckless in not  
 2 adequately supervising the internal control and disclosure mechanisms at  
 3 Countrywide to prevent the manipulations set forth above. *See, e.g., Middlesex*,  
 4 547 F. Supp. 2d at 1189-90.<sup>57</sup>

5 Similarly, the Director Defendants each signed Countrywide's Form 10-Ks,  
 6 and this complements the other allegations demonstrating their scienter. *Howard*  
 7 *v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 (9th Cir. 2000) (“[W]hen a corporate  
 8 officer signs a document on behalf of the corporation, that signature will be  
 9 rendered meaningless unless the officer believes that the statements in the  
 10 document are true.”); *Middlesex*, 527 F. Supp. 2d at 1190 (“[S]everal Defendants  
 11 also signed proxy forms and other publicly reported financial disclosures. The  
 12 financial disclosures, proxy statements, and SOX Certifications are clearly  
 13 ‘statements’ for the purposes of establishing contemporaneous knowledge.”).

### 14 3. Plaintiffs’ Information And Belief Allegations Are Sufficient

15 Ignoring whole portions of the Complaint, Defendants assert that “Plaintiffs’  
 16 allegations are derived apparently from two sources”: (1) “data tables . . .  
 17 constructed from CFC’s SEC filings” and (2) the accounts of confidential  
 18 witnesses that “are too vague and lacking in context to be reliable.” Ind. Defs.’  
 19

20 regardless of who prepared the statements, the signatories are attesting  
 21 to their accuracy and reliability.

22 *Middlesex*, 527 F. Supp. 2d at 1189-90; *see also In re Proquest Sec. Litig.*, 2007  
 23 WL 3275109, at \*12 (E.D. Mich. Nov. 6, 2007) (rejecting argument that SOX  
 24 certifications cannot raise a strong inference of scienter and explaining that an  
 25 officer’s “signature will be rendered meaningless unless the officer believes that  
 26 the statements in the document are true”); *In re Lattice Semiconductor Corp. Sec.*  
 27 *Litig.*, 2006 WL 538756, at \*17-18 (D. Or. Jan. 3, 2006) (same).

28 <sup>57</sup> *See also Proquest*, 2007 WL 3275109, at \*13 (“The SOX certifications give rise  
 to an inference of [defendant]’s scienter because they provide evidence either that  
 he knew about the improper accounting practices or, alternatively, knew that the  
 controls he attested to were inadequate.”); *In re Am. Italian Pasta Co. Sec. Litig.*,  
 2006 WL 1715168, at \*5 (W.D. Mo. June 19, 2006) (by signing SOX certifications,  
 defendants attested that they were “either aware of the improper accounting, [were]  
 reckless with regard to the public reports of [defendant’s] finances, or had not  
 conducted any review and did not act in accordance with the certifications”).

1 Mem. at 16-18. On the contrary, the Complaint is well supported by, among other  
2 things: (i) the findings of numerous independent investigations conducted by trust-  
3 worthy third parties, (ii) Defendants' own admissions, and (iii) the accounts of  
4 numerous former employees of the Company who personally witnessed the facts  
5 attributed to them and whose accounts are consistent and corroborated by the  
6 myriad facts unearthed by Plaintiffs' investigation.

7 Plaintiffs plead, for example, independent investigations by third parties that  
8 discovered Countrywide's risky lending activities. For instance, *The Wall Street*  
9 *Journal* hired investment bank UBS AG to investigate Countrywide and in October  
10 2007 revealed that the Company had increased production of pay-option ARMs by  
11 "giving these loans to riskier and riskier borrowers." ¶115; see also ¶¶116-17, 203.  
12 Similarly, *The New York Times*, based on the Company's own internal documents  
13 obtained from Company employees, revealed in August 2007 that "Countrywide  
14 was willing to underwrite loans that left little disposable income for borrowers'  
15 food, clothing and other living expenses," rendering it highly unlikely such  
16 borrowers could repay their loans. ¶¶180-82. At the same time, U.S. Senator  
17 Charles Schumer, a member of the Senate Banking Committee, declared  
18 Countrywide was steering borrowers to high-cost loans that "are largely designed  
19 to fail the borrower" because of the excess prepayment fees. ¶186. As set forth in  
20 the Complaint and above, numerous independent sources support Plaintiffs'  
21 allegations that the Company was engaging in risky lending activities.

22 In addition to these various independent sources, as explained above,  
23 Defendants' own statements support the falsity of prior statements and their  
24 scienter. For example, Defendants themselves admitted that they were actively  
25 monitoring the various business aspects of Countrywide, including most  
26 importantly, its underwriting practices.

1 Instead of addressing the Complaint's detailed allegations, Defendants  
2 attempt to create a "mini-trial" over the credibility of the confidential witnesses  
3 whose firsthand accounts corroborate the Complaint's allegations. Ind. Defs.'  
4 Mem. at 17-18. Contrary to Defendants' position, the PSLRA's pleading  
5 requirements do not require Plaintiffs to name their confidential sources, provided  
6 they "are described 'with sufficient particularity to support the probability that a  
7 person in the position occupied by the source would possess the information  
8 alleged' and the complaint contains 'adequate corroborating details.'" *Daou*, 411  
9 F.3d at 1015. In *Daou*, the complaint satisfied these requirements where it  
10 "describe[d] the confidential witnesses with a large degree of specificity,"  
11 "number[ed] each witness and describ[ed] his or her job description and  
12 responsibilities," and "[i]n some instances, plaintiffs provide[d] the witnesses'  
13 exact title and to which Daou executive the witness reported." *Id.* at 1016.

14 Here too, the Complaint includes this detailed information with sufficient  
15 particularity to support the probability that persons in their positions would possess  
16 the information alleged.<sup>58</sup> Nothing more is required.

17 Defendants' citation to *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753 (7th  
18 Cir. 2007), for the proposition that confidential witnesses should be ignored, is  
19 unavailing. *Higginbotham* does not address the standard in the Ninth Circuit,  
20 which standard continues to apply after the *Tellabs* decision.<sup>59</sup> Since *Tellabs*,  
21 courts have continued to accept as true – as they must – allegations based on  
22 witness accounts in finding a strong inference of scienter.<sup>60</sup> As Defendants  
23

24 <sup>58</sup> ¶¶147, 154-68; see also ¶¶148-53 (accounts of *named* former employees).

25 <sup>59</sup> See *Daou*, 411 F.3d at 1015; *In re InfoSonics Corp. Sec. Litig.*, 2007 WL  
26 2301757, at \*7 (S.D. Cal. Aug. 7, 2007) (applying *Daou* analysis to confidential  
witnesses after *Tellabs*).

27 <sup>60</sup> See, e.g., *In re NPS Pharms., Inc. Sec. Litig.*, 2007 WL 1976589, at \*6 (D. Utah  
28 July 3, 2007). Even the aberrant opinion in *Higginbotham* acknowledges that  
allegations based on confidential witnesses may support scienter, but only that  
such allegations were "discounted" in that case. 2007 WL 2142298, at \*2-3.

1 acknowledge, courts in this circuit have refused to follow *Higginbotham* and  
2 subsequent Seventh Circuit opinion does not interpret its holding as Defendants do  
3 here.<sup>61</sup> Moreover, unlike the confidential witnesses in *Higginbotham*, the  
4 Confidential Witnesses here worked directly for Countrywide, and were in  
5 positions to know the information stated. The Complaint meets Ninth Circuit  
6 standards.

7 Defendants also argue that the Confidential Witnesses cannot be relied upon,  
8 either because they (purportedly) were “too low-level” or because (other than  
9 CW11) they (purportedly) had no direct contact with Defendants. Ind. Defs.’  
10 Mem. at 17-18. In the Ninth Circuit, however, a complaint need only “support the  
11 probability that a person in the position occupied by the source would possess the  
12 information alleged.” *Daou*, 411 F.3d at 1015. There is no requirement that the  
13 witness participate in any decision-making or financial reporting. To do so would,  
14 in many cases, eliminate all potential witnesses except those who themselves  
15 perpetuated the fraud (most often, the defendants).

#### 16 4. The Complaint Sufficiently Pleads Reliance

17 Defendants contend that the § 10(b) claims must fail because the Director  
18 Defendants could not have relied upon their own false and misleading statements  
19 in approving the Company’s stock buyback program; *i.e.*, the Director Defendants  
20 could not have deceived the Company because the Director Defendants’ scienter is  
21 imputed to the Company. Ind. Defs.’ Mem. at 19. However, “[i]t is by now well  
22 established that a corporation has a claim under § 10(b) if the corporation was  
23 defrauded in respect to the sale of its own securities by some or even all of its  
24

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25  
26 <sup>61</sup> See *In re Wet Seal, Inc. Sec. Litig.*, 518 F. Supp. 2d 1148, 1170 (C.D. Cal.  
27 2007); see also *InfoSonics*, 2007 WL 2301757, at \*7. The Seventh Circuit itself –  
28 the Court that issued *Higginbotham* – does not interpret its holding as Defendants  
do here. In *Makor*, the unanimous panel held: “[T]he absence of proper names  
does not invalidate the drawing of a strong inference from informants’ assertions.”  
513 F.3d 702, 711-12 (7th Cir. 2008) (citing *Daou*, 411 F.3d at 1015-16).

1 directors.” *Estate of Soler v. Rodriguez*, 63 F.3d 45, 54 (1st Cir. 1995). Courts  
2 have routinely addressed and rejected Defendants’ contention:

3 We come then to the question whether it is possible within the  
4 meaning of Section 10(b) and Rule 10B-5 for a corporation to be  
5 defrauded by a majority of its directors. We note at the outset that in  
6 other contexts, such as embezzlement and conflict of interest, a  
7 majority or even the entire board of directors may be held to have  
8 defrauded their corporation. When it is practical as well as just to do  
9 so, *courts have experienced no difficulty in rejecting such cliches as*  
10 *the directors constitute the corporation and a corporation, like any*  
11 *other person, cannot defraud itself.*

12 [W]e can think of no reason to say that redress under Rule  
13 10b-5 is precluded, though it would have been available had anyone  
14 else committed the fraud. *There can be no more effective way to*  
15 *emasculate the policies of the federal securities laws than to deny*  
16 *relief solely because a fraud was committed by a director rather than*  
17 *by an outsider.*

18 *Ruckle v. Roto Am. Corp.*, 339 F.2d 24, 29 (2d Cir. 1964) (emphasis added). It is  
19 still “the general rule that the knowledge of the allegedly defrauding directors will  
20 not be imputed to the corporation to negate reliance without disclosure by the  
21 allegedly defrauding directors and ratification by the remaining directors or  
22 shareholders.”<sup>62</sup> “Under this rule, Defendants’ argument that [ ] Plaintiffs have  
23  
24  
25

26 <sup>62</sup> *In re Whitehall Jewelers, Inc. S’holder Deriv. Litig.*, 2006 WL 468012, at \*12  
27 (N.D. Ill. Feb. 27, 2006); *see also Zoran*, 511 F. Supp. 2d at 1011-12 (recognizing  
28 that a derivative action “does not resemble the classic securities case” and holding  
that plaintiffs adequately alleged company relied upon statements made by director  
defendant for purposes of 10b-5 claim).

1 pleaded themselves out of court fails.” *Id.*<sup>63</sup>

2 C. **The Complaint Adequately Alleges A Claim Under Section 14(a)**

3 Section 14(a) of the Exchange Act, and Rule 14a-9, prohibit the  
4 dissemination of a proxy statement that is “false or misleading” to solicit a proxy.  
5 15 U.S.C. § 78n(a). To state a claim under § 14(a), a plaintiff must show (1) that  
6 the proxy solicitation contains a false or misleading statement of material fact or  
7 omits to state a material fact necessary to make statements in the solicitation not  
8 false or misleading; (2) that the misstatement or omission of a material fact was the  
9 result of knowing, reckless or negligent conduct; and (3) that the misstatement or  
10 omission caused injury. *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438  
11 (1976). Unlike § 10(b) of the Exchange Act, however, a claim under § 14(a) must  
12 only “plead with particularity facts that give rise to a strong inference of  
13 **negligence.**” *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1267  
14 (N.D. Cal. 2000) (emphasis added).

15 Here, the Complaint specifically pleads that Countrywide’s proxy statements  
16 for 2005 through 2007 were materially false and misleading because they failed to  
17 disclose the true operational and financial results of the Company. *See, e.g.*,  
18 ¶¶307-308, 310. In turn, the false financial results were used as performance  
19 metrics to increase compensation for executives in the 2005 Annual Incentive Plan  
20 and the 2006 Equity Incentive Plan. *Id.*; *see also* ¶¶543-44. Moreover, the  
21 Directors solicited proxy votes in favor of the incentive plans while discouraging  
22 shareholders from voting in favor of a proposal that would have required annual

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23  
24 <sup>63</sup> Defendants cite only one authority purportedly supporting their contention that  
25 reliance is negated where the “same persons who made the alleged misstatements  
26 also made CFC’s repurchase decision.” *Ind. Defs.’ Mem.* at 19 (citing *In re*  
27 *Verisign, Inc., Deriv. Litig.*, 2007 WL 2705221, at \*32 (N.D. Cal. Sep. 14, 2007)).  
28 In *Verisign*, however, the district court did not cite any authority considering the  
reliance requirement in the context of a derivative action as is the case here. The  
great weight of authority holds that in derivative actions, reliance is not negated by  
the defendants’ own fraudulent intent – to do so would, as recognized by the  
Second Circuit, “emasculate” the federal securities laws. *Ruckle*, 339 F.2d at 29.

1 approval of executive compensation. ¶¶312-14, 318, 541. Any reasonable and  
2 prudent director would not have permitted such false and misleading statements to  
3 be published. The Company has thus been harmed as a result of the increased  
4 compensation paid pursuant to the incentive plans based on the false and  
5 misleading performance metrics. ¶547. As such, the Complaint adequately pleads  
6 a claim under § 14(a).

7 Defendants misconstrue the allegations and assert that they amount to  
8 nothing more than an immaterial failure to disclose breaches of fiduciary duty.  
9 Ind. Defs' Mem. at 21; Dougherty Mem. at 24-25. This is not the case. A  
10 misrepresentation or omission is material if there is a “substantial likelihood that  
11 the disclosure of the omitted fact would have been viewed by the reasonable  
12 investor as having significantly altered the “total mix” of information made  
13 available.” *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Because  
14 materiality is a highly factual question, however, it should not be determined on a  
15 motion to dismiss.<sup>64</sup> Despite Defendants' improper materiality argument, it is clear  
16 even at the pleadings stage that artificially inflated operational and financial results  
17 used to boost executive compensation, as alleged here, are material facts.

18 D. The Complaint Alleges Control Person Liability Under Section 20(a)

19 A complaint sufficiently states a claim for control person liability under  
20 § 20(a) of the Exchange Act if it alleges: (1) a primary violation of the securities  
21 laws; and (2) that a defendant possessed power or control that directly or indirectly  
22 induced a violation of the securities laws. *See Am. West*, 320 F.3d at 945.

23 The Complaint satisfies the first element required of § 20(a) by pleading a  
24 primary violation of the federal securities laws. *See, supra*, §§ II.B. As to the  
25 second element, the SEC has defined “control” to include “the possession, direct or  
26

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27 <sup>64</sup> *See, e.g., In re Surebeam Corp. Sec. Litig.*, 2005 WL 5036360, at \*5 (S.D. Cal.  
28 Jan. 3, 2005) (“Materiality is ordinarily a factual question [r]eserved for the jury.”).

1 indirect, of the power to direct or cause the direction of the management and  
2 policies of a person, whether through the ownership of voting securities, by  
3 contract, or otherwise.” 17 C.F.R. § 230.405. The Complaint adequately alleges  
4 facts demonstrating that Defendants were controlling persons vested with the  
5 “power to direct” the “management and policies” of Countrywide during the  
6 Relevant Period within the meaning of § 20(a), which ““was enacted to expand  
7 rather than restrict the scope of liability under the securities laws.”” *Hollinger v.*  
8 *Titan Capital Corp.*, 914 F.2d 1564, 1577 (9th Cir. 1990). The Complaint  
9 specifically alleges that Defendants:

- 10 • owned or controlled substantial quantities of Countrywide stock (¶¶322,  
11 325-26, and App. A) – a factor expressly identified by the SEC in  
12 defining “control”;<sup>65</sup>
- 13 • exercised authority over Countrywide’s SEC filings, press releases, and  
14 participated in conference calls with investors (¶¶276-320);
- 15 • directed the operations of Countrywide (¶¶132-230); and
- 16 • occupied positions of control on Countrywide’s Board of Directors  
17 (¶¶72-97, as discussed, *supra*, §§ II.A.2, II.B.2.b(2)).

18 Defendant Dougherty is the only individual defendant expressly contesting  
19 liability under § 20(a) of the Exchange Act. *See* Dougherty Mem. at 23 n.40.  
20 Without citing any authority, he baldly asserts that § 20(a) is unavailable as a  
21 derivative claim because he is only alleged to have controlled Countrywide (the  
22 injured party) and not another primary violator of the Exchange Act. Dougherty  
23 Mem. at 23 n.40. This argument fails. Countrywide is a nominal defendant in this  
24 derivative action and control over such a corporate entity is sufficient for § 20(a)  
25 liability. *See Am. West*, 320 F.3d at 945 (“Section 20(a) provides joint and several  
26 liability for controlling persons who aid and abet violations of the 1934 Act.”). As

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27  
28 <sup>65</sup> 17 C.F.R. § 230.405.

1 alleged in the Complaint, Defendants, including Defendant Dougherty, caused  
2 Countrywide to issue false and misleading statements throughout the Relevant  
3 Period. ¶¶287-88; and 289-90. Indeed, Defendant Dougherty signed false and  
4 misleading Form 10-Ks filed with the SEC on Countrywide's behalf. *Id.* As a  
5 Director, Defendant Dougherty was in a position of control to prevent the issuance  
6 of such false and misleading statements on behalf of Countrywide in violation of  
7 the Exchange Act. Such conduct is sufficient for control liability in the Ninth  
8 Circuit.<sup>66</sup>

9 Defendant Dougherty also argues that the control allegations are insufficient  
10 because they fail to allege specific evidence of his actual control in the form of  
11 day-to-day involvement in the affairs of Countrywide. Dougherty Mem. at 23  
12 n.40. Such a requirement goes beyond what is needed to allege control liability in  
13 the Ninth Circuit.<sup>67</sup> “[I]t is not necessary to show actual participation or the  
14 exercise of actual power” to plead that a defendant is a control person.<sup>68</sup> Applying  
15

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16  
17 <sup>66</sup> See *Howard*, 228 F.3d at 1066 (“actual authority over the preparation and  
18 presentation to the public of the financial statements is sufficient to make out a  
19 prima facie case [of control person liability],” even despite assertions that such an  
20 individual never participated in drafting the statements).

21 <sup>67</sup> To adequately plead that a defendant controlled a primary violator, the  
22 Complaint must only meet the notice pleading standard of Fed. R. Civ. P. 8. See  
23 *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 513 (2002); *In re WorldCom, Inc. Sec.*  
24 *Litig.*, 294 F. Supp. 2d 392, 415-16 (S.D.N.Y. 2003) (For the purposes of pleading  
25 the control element of a § 20(a) claim “[a] short, plain statement that gives the  
26 defendant fair notice of the claim that the defendant was a control person and the  
27 ground on which it rests its assertion that a defendant was a control person is all  
28 that is required.”). Furthermore, whether one is a control person is “an intensely  
factual question.” *Am. West*, 320 F.3d at 945. As a result, the issue of actual  
control cannot be resolved by a motion to dismiss.

<sup>68</sup> *Howard*, 228 F.3d at 1065; see also *Am. West*, 320 F.3d at 945 (quoting  
*Howard*). Even the earlier Ninth Circuit opinion cited by Defendant Dougherty,  
*Paracor Fin., Inc. v. GE Capital Corp.*, is clear that a control “inquiry must  
revolve around the ‘management and policies’ of the corporation, not around  
discrete transactions.” 96 F.3d 1151, 1162 (9th Cir. 1996). Similarly, the two  
additional district court cases cited by Dougherty for the proposition that the Court  
must make an inquiry into the day-to-day involvement of a defendant for control  
liability purposes, *In re Turbodyne Techs., Inc. Sec. Litig.*, 2000 WL 33961193  
(C.D. Cal. Mar. 15, 2000), and *Ruble v. Rural/Metro Corp.*, 2001 WL 1772319 (D.

1 the broad definition of control in the statute, the SEC regulation, and the Ninth  
2 Circuit authority, however, the Complaint adequately pleads control liability for  
3 the Individual Defendants under § 20(a) of the Exchange Act.

4 E. The Complaint Pleads Insider Trading Claims Under Section 20A

5 Section 20A of the Exchange Act provides a private right of action to those  
6 harmed by illegal insider sales when purchasing stock contemporaneously with a  
7 defendant who sold while in possession of material, non-public information.  
8 15 U.S.C. § 78t(d).

9 Here, the Complaint alleges that in both November 2006 and May 2007, the  
10 Company repurchased over 60 million shares of its stock, at a cost of over \$2.4  
11 billion, funded by issuing debt securities. ¶327. Specifically, Countrywide  
12 purchased 38,641,941 shares of its common stock in November 2006, at an  
13 average price of \$38.82 per share. At the same time, in November 2006,  
14 Defendants Cunningham, Dougherty, Garcia, Mozilo, Robertson and Sambol sold  
15 669,789 shares of Countrywide stock for proceeds of over \$26 million.  
16 Countrywide then purchased an additional 21,507,817 shares of common stock in  
17 May 2007, at an average price of \$40.39 per share. ¶537. Also, during May 2007,  
18 Defendants Cisneros, Dougherty, Garcia and Mozilo sold 615,761 shares of  
19 Countrywide stock for proceeds of over \$24 million.<sup>69</sup> These allegations,  
20 combined with the particular claims of the Individual Defendants' violations of  
21

22  
23 Ariz. Jan. 26, 2001), both pre-date the Ninth Circuit's decision in *America West*,  
24 which rejected such an argument at the pleading stage, holding that the inquiry is  
25 reserved for the trier of fact. *See Am. West*, 320 F.3d at 945.

26 <sup>69</sup> *Id.* These figures represent Defendants' sales during the two months (November  
27 2006 and May 2007) in which Countrywide has disclosed that it was repurchasing  
28 stock. For scienter purposes, however, the Complaint and this opposition detail  
Defendants' sales throughout the entire Relevant Period. For example, Defendants  
took advantage of Countrywide's inflated stock price and sold their personal  
holdings to coincide with the buy-back during the fourth quarter of 2006, when the  
repurchase program was announced, and the second quarter of 2007, when the  
repurchase program concluded.

1 §§ 10(b), 20(a) and 14(a) of the Exchange Act (*see, supra*, §§ II.B. through II.D),  
2 are more than sufficient to plead a violation of § 20A of the Exchange Act.<sup>70</sup>

3 Despite this, Defendants argue that the § 20A claim should be dismissed  
4 because, in their view, the Complaint fails to allege a predicate violation of the  
5 Exchange Act. Ind. Defs' Mem. at 19-20; Dougherty Mem. at 23-24. As  
6 demonstrated throughout this memorandum, however, the Complaint adequately  
7 alleges that Defendants are liable under the Exchange Act, and therefore, dismissal  
8 is unwarranted on this ground.

9 Moreover, Defendants contend that the repurchases of common stock by  
10 Countrywide were not "contemporaneous" with Defendants' sales. Ind. Defs'  
11 Mem. at 20; Dougherty Mem. at 23-24. Although the Complaint details that  
12 Countrywide's repurchases occurred within the same months as the alleged insider

13  
14 <sup>70</sup> Moreover, the Complaint satisfies all pleading obligations for loss causation  
15 under *Dura Pharms.*, 544 U.S. 336. Under *Dura*, a plaintiff need only "provide[] a  
16 defendant with some indication of the loss and the causal connection that the  
17 plaintiff has in mind." *Id.* at 347. This standard is "not meant to impose a great  
18 burden upon a plaintiff," and a complaint is sufficient so long as it sets forth the  
19 alleged loss and causal connection to the fraud consistent with Rule 8 of the  
20 Federal Rules of Civil Procedure. *Id.* at 336. The Complaint clearly meets this  
21 standard by setting forth a detailed loss causation analysis. ¶¶485-89. Moreover,  
22 despite Defendant Dougherty's assertion that the Complaint pleads no economic  
23 loss, and only alleges purchase price inflation in connection with Countrywide's  
24 share repurchases in November 2006 and May 2007, the facts point to the contrary.  
25 Dougherty Mem. at 22-23. In fact, Countrywide incurred over \$2.4 billion in debt  
26 while purchasing inflated shares as part of the repurchase program approved by the  
27 Board of Directors, including Defendant Dougherty, while Defendants concealed  
28 knowledge of the irresponsible lending practices, including the need to increase  
allowances for loan losses and the impairment of retained loan interests. ¶327.  
This debt, among other things, drove Countrywide to the brink of failure. Further,  
one of the state claims at issue calculates damages based on purchase price  
inflation – damages for violations of Cal. Corp. § 25402 are defined in terms of  
inflation at the time of purchase:

Any person who violates Section 25402 shall be liable to the person  
who purchases a security from him or sells a security to him, for  
***damages equal to the difference between the price at which such  
security was purchased*** or sold and the market value which such  
security would have had at the time of the purchase or sale if the  
information known to the defendant had been publicly disseminated  
prior to that time and a reasonable time had elapsed for the market to  
absorb the information . . . .

Cal. Corp. Code § 25502 (emphasis added).

1 sales (November 2006 and May 2007), Defendants insist that this does not  
2 constitute “contemporaneous” trading under § 20A. *Id.* Essentially, Defendants  
3 argue for an improperly narrow view of what constitutes “contemporaneous”  
4 trading under § 20A, despite the fact that the statute and the Ninth Circuit have not  
5 defined the term.<sup>71</sup> Indeed, the Ninth Circuit specifically refrained from  
6 determining the “exact contours of ‘contemporaneous trading.’” *Neubronner v.*  
7 *Milken*, 6 F.3d 666 (9th Cir. 1993). Moreover, contrary to Defendants’ assertions,  
8 a recent decision from this district held that contemporaneous trading can  
9 encompass an entire period where sales were made on the basis of inside  
10 information.<sup>72</sup>

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15 <sup>71</sup> Moreover, Defendants are inconsistent in their arguments as to what constitutes  
16 “contemporaneous trading.” Defendant Dougherty asserts that the trades must  
17 occur within a “few days,” while the other Individual Defendants contend that  
18 § 20A requires “same-day trading.” *Compare* Dougherty Mem. at 24, *with* Ind.  
19 Defs’ Mem. at 20.

20 <sup>72</sup> *Middlesex*, 527 F. Supp. 2d at 1195-96 (citing *In re Am. Bus. Computers Corp.*  
21 *Sec. Litig.*, 1994 WL 848690, at \*4 (S.D.N.Y. Feb. 24, 1994)). The *Middlesex*  
22 court specifically rejected the same-day trading requirement in *In re AST Research*  
23 *Sec. Litig.*, 887 F. Supp. 231, 233 (C.D. Cal. 1995), which Individual Defendants  
24 cite and rely upon here. Ind. Defs’ Mem. at 20. The court in *Middlesex* held:  
25 “Given that the Ninth Circuit has explicitly declined to define the contours of the  
26 ‘contemporaneous’ requirement, after examining various approaches, the Court  
27 follows the more persuasive rule, that of Judge Bricant in *Am. Bus. Computers*  
28 *Corp.*” *Middlesex*, 527 F. Supp. 2d at 1196.

Further, Defendants assert that § 20A is limited to “unsophisticated traders”  
in direct actions. Ind. Defs’ Mem. at 20. A § 20A claim is not limited to  
unsophisticated traders – on its face the statute is clear that “*any person*” who  
contemporaneously purchases as an insider sells while in possession of material  
non-public information may pursue a claim. 15 U.S.C. § 78t(d) (emphasis added).  
In fact, sophisticated institutional investors have asserted § 20A claims in this very  
district. *See, e.g., Middlesex*, 527 F. Supp. 2d at 1195-96 (§ 20A claim asserted by  
Massachusetts pension fund). Similarly, as the Ninth Circuit held, “parties who  
have traded with someone who had an unfair advantage will be able to maintain  
insider trading claims.” *Neubronner*, 6 F.3d at 670. Defendants possessed an  
unfair trading advantage over Countrywide by forcing it to detrimentally purchase  
shares at the same time as they sold stock.

1 F. The Complaint Adequately Alleges State Law Claims

2 1. The Complaint Adequately Alleges Claims For Breach  
 3 Of Fiduciary Duty, Gross Mismanagement And Waste

4 Officers and directors of a corporation owe a fiduciary obligation to the  
 5 company and its stockholders.<sup>73</sup> “This duty has been consistently defined as  
 6 ‘broad and encompassing,’ demanding of a director ‘the most scrupulous  
 7 observance.’” *BelCom, Inc. v. Robb*, 1998 WL 229527, at \*3 (Del. Ch. Apr. 28,  
 8 1998) (internal citations omitted). As such, “[w]henver directors communicate  
 9 publicly or directly with shareholders about the corporation’s affairs, with or  
 10 without a request for shareholder action, directors have a fiduciary duty to  
 11 shareholders to exercise due care, good faith and loyalty. It follows a fortiori that  
 12 when directors communicate publicly or directly with shareholders about corporate  
 13 matters the sine qua non of directors’ fiduciary duty to shareholders is honesty.”<sup>74</sup>

14 Moreover, under Delaware law, “liability may arise for the breach of the  
 15 duty to exercise appropriate attention to potentially illegal corporate activities from  
 16 ‘an unconsidered failure of the board to act in circumstances in which due attention  
 17 would, arguably, have prevented the loss.’”<sup>75</sup> Thus, “‘a sustained or systematic  
 18 failure of the board to exercise oversight . . . will establish the lack of good faith  
 19 that is a necessary condition to liability.’” *Id.* (citation omitted).<sup>76</sup>

20  
 21 <sup>73</sup> See *Jackson Nat'l Life Ins. Co., v. Kennedy*, 741 A.2d 377, 386 (Del. Ch. 1999);  
*Arnold v. Soc’y for Sav. Bancorp*, 678 A.2d 533, 539 (Del. 1996).

22 <sup>74</sup> *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998) (holding that “directors who  
 23 knowingly disseminate false information that results in corporate injury or damage  
 24 to an individual stockholder violate their fiduciary duty, and may be held  
 25 accountable in a manner appropriate to the circumstances”).

26 <sup>75</sup> *In re Abbott Labs. Deriv. S'holders Litig.*, 325 F.3d 795, 808 (7th Cir. 2003)  
 27 (quoting *In re Caremark Int'l*, 698 A.2d 959, 967 (Del. Ch. 1996)).

28 <sup>76</sup> The Complaint also alleges sufficient facts demonstrating aiding and abetting a  
 breach of fiduciary duty as the Individual Defendants assisted one another in a  
 deliberate course of action designed to divert corporate funds through the approval  
 of incentive compensation plans based on false corporate metrics. Such allegations  
 of a deliberate course of action are sufficient to state a claim for aiding and  
 abetting liability. See *In re Scott Acquisition Corp.*, 344 B.R. 283, 290 (Bankr. D.  
 Del. 2006).

1 Despite this, Defendants assert that the breach of fiduciary duty and gross  
2 mismanagement claims here merely amount to a failure of oversight without any  
3 showing of bad faith or personal benefit. Ind. Defs' Mem. at 22-24; Dougherty  
4 Mem. at 4. The Complaint is clear, however, that Defendants possessed  
5 knowledge of the Company's risky lending practices and lax internal controls, but  
6 concealed this information from the market through false and misleading  
7 statements, and at the same time forced the Company to spend billions of dollars  
8 on a stock repurchase program while the individuals sold millions of dollars of  
9 their own stock. Such facts, taken together, create "reasonable inferences" that  
10 Defendants breached their duties of good faith, care and loyalty.<sup>77</sup>

11 Similarly, Defendants challenge the claim of waste for failing to show that  
12 the Board made a bad faith judgment when it awarded executive compensation and  
13 instituted the repurchase program. Ind. Defs' Mem. at 24; Dougherty Mem. at 16.  
14 Such an argument, however, is inappropriate at the motion to dismiss stage in the  
15 context of a waste claim that concerns "a transfer of corporate assets that serves no  
16 corporate purpose," as is alleged here. *Lewis v. Vogelstein*, 699 A.2d 327, 336  
17 (Del. Ch. 1997). Such allegations of waste are "inherently factual and not easily  
18 amenable to determination on a motion to dismiss." *Id.* at 339.

19 Regardless, even if appropriate for determination at the motion to dismiss  
20 stage, as explained above, the Complaint sufficiently alleges Defendants' bad faith  
21 judgment – including ignoring their outside consultants when approving Mozilo's  
22 massive compensation packages. Likewise, Defendants' bad faith in forcing the

23 \_\_\_\_\_  
24 <sup>77</sup> *In re Taser Int'l S'holder Deriv. Litig.*, 2006 WL 687033, at \*16 (D. Ariz. Mar.  
25 17, 2006) ("the various disclosure allegations were part of a scheme to artificially  
26 inflate [the company's] stock price so that Defendants could sell material portions  
27 of their holdings around the same time, [as such] the Court concludes that at this  
28 stage of the proceedings that Plaintiffs have adequately pleaded that the alleged  
disclosure violations implicated the duties of **good faith, due care and loyalty.**")  
(emphasis added); see also *Stone*, 911 A.2d at 370 ("Where directors fail to act . . .  
demonstrating a conscious disregard for their responsibilities, they breach their  
duty of loyalty by failing to discharge that fiduciary obligation in good faith.").

1 Company to borrow money and then buy its own shares at inflated prices –while  
 2 Defendants personally unloaded their own shares – is sufficiently pled.

3 2. The Complaint Pleads Claims Under  
 4 Cal. Corp. Code Section 25402

5 California Corporations Code § 25402 prohibits insider trading while in  
 6 possession of material non-public information. “The very purpose of [§§ 25402  
 7 and 25502.5] is to ‘afford the victims of securities fraud with a remedy without the  
 8 formidable task of proving common law fraud.’”<sup>78</sup> The law is clear that “a  
 9 fiduciary is subject to a duty not to use on his own account information acquired by  
 10 him in the course of his fiduciary relationship.”<sup>79</sup> While Defendants assert that the  
 11 insider trading allegations lack particularity (Ind. Defs’ Mem. at 24-25; Dougherty  
 12 Mem. at 17), as demonstrated above, the Complaint adequately pleads facts  
 13 demonstrating that Defendants’ stock sales during the Relevant Period occurred  
 14 while they possessed material, non-public information.

15 III. CONCLUSION

16 For the reasons stated above, Plaintiffs request that the Court deny  
 17 Defendants’ motions to dismiss. Should the Court grant any portion of the motions  
 18 to dismiss, Plaintiffs respectfully request an opportunity to amend the pleadings.<sup>80</sup>

19 Dated: April 4, 2008

Respectfully submitted,

20 BERNSTEIN LITOWITZ BERGER  
 & GROSSMANN LLP

21 /s/ Blair A. Nicholas

22 BLAIR A. NICHOLAS

23  
 24 <sup>78</sup> *Mirkin v. Wasserman*, 5 Cal. 4th 1082, 1102 (1993) (internal citations omitted).

25 <sup>79</sup> *In re Sagent Tech.*, 278 F. Supp. 2d 1079, 1092 (N.D. Cal. 2003) (citing *Brophy*  
*v. Cities Serv. Co.*, 70 A.2d 5, 7-8 (Del. Ch. 1949).

26 <sup>80</sup> In the Ninth Circuit, leave to amend is freely given unless the complaint could  
 27 not possibly be cured by the allegation of other facts. “Adherence to these  
 28 principles is especially important in the context of the PSLRA . . . . In this  
 technical and demanding corner of the law, the drafting of a cognizable complaint  
 can be a matter of trial and error.” *Eminence Capital, L.L.C. v. Aspeon, Inc.*, 316  
 F.3d 1048, 1052 (9th Cir. 2003) (*per curiam*); *see also* Fed. R. Civ. P. 15.

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