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13 SUPERIOR COURT OF THE STATE OF CALIFORNIA  
14 IN AND FOR THE COUNTY OF SAN FRANCISCO

DCC-09-487492

16 **CITY OF SAN BUENAVENTURA,**  
17 **Plaintiff,**

18 vs.

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

CIVIL ACTION NO.:  
COMPLAINT FOR:  
1. Fraud and Deceit  
2. Negligent Misrepresentation  
3. Breach of Fiduciary Duty and  
4. Violations of Calif. Corp. Code § 25400  
*et seq.*

JURY TRIAL DEMANDED

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

6 **I. INTRODUCTION**

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

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

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

1           4.       In 2008, WaMu finally revealed the full extent of its losses, acknowledging  
2 that its portfolio of supposedly high-quality home loans was tainted with substantially impaired  
3 assets. WaMu is now in default on coupon payments to the City. As a result, the City has  
4 suffered substantial losses.

5 **II.     JURISDICTION AND VENUE**

6           5.       Plaintiff, the City of San Buenaventura, was incorporated by the California  
7 Legislature in 1866. The City invests its public funds pursuant to the California Government  
8 Code. The City's pooled funds are managed by the City's Treasurer on behalf of the City. The  
9 City was solicited to purchase its interest in a WaMu note in California and the purchase was  
10 consummated in California. The City held and continues to hold the note in its custodial account  
11 in California.

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

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

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

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

5       **III.    THE PARTIES**

6           **A.    Plaintiff**

7           10.       Plaintiff is **the City of San Buenaventura**. The City is one of the oldest  
8 settlements on the Pacific Coast. It is the site of the San Buenaventura Mission founded in 1782,  
9 and incorporated as a town by the California Legislature in 1866. The City invests its public  
10 funds pursuant to the California Government Code. The City's investments are managed by the  
11 San Buenaventura City Treasurer on behalf of the City.

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

14           **B.    Defendants**

15                   **1.    Officer Defendants**

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

1           13.     Defendant **Thomas Casey** (“Casey”) served as Executive Vice President  
2 and Chief Financial Officer of WaMu since October 2002. Casey also served as a member of  
3 the Executive Committee since 2002, overseeing the Company’s corporate finance, strategic  
4 planning and investor relations functions. From 2005 through 2007, Casey received over \$11  
5 million in total compensation, including at least \$3 million in bonus compensation.

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

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

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

26           17.     Defendants Killinger, Casey, Cathcart, Rotella, and Schneider are referred to  
27 as the “Officer Defendants.”

1                   **2.     Director Defendants**

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

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

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

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

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

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



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

8           **C. Auditor Defendant**

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

16           **D. Doe Defendants**

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

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

1           **E.     Agents and Co-Actors**

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

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

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

13           **F.     Unnamed Participants**

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

20           **IV.    FACTUAL ALLEGATIONS**

21           **A.     The City And Its Investments**

22                   **1.     State Law Authority And Requirements**

23           32.     California Government Code Section 53630.1 states, “The Legislature hereby  
24 finds that the solvency and creditworthiness of each individual local agency can impact the  
25 solvency and creditworthiness of the state and other local agencies within the state and all of its  
26 political subdivisions, the Legislature hereby declares that the deposit and investment of public  
27 funds by local officials and local agencies is an issue of state wide concern.” Based on this  
28

1 policy, California Legislature enacted several statutes governing the investment of a city or  
2 county's surplus public funds, including the types and amounts of such investments. Cal. Govt.  
3 Code § 53600, et seq.

4 33. Pursuant to state law, the primary objectives in managing public funds, in order of  
5 priority, are to 1) safeguard the principal of the funds; 2) satisfy the liquidity needs of depositors;  
6 and 3) achieve a return on the funds. Cal. Govt. Code §§ 27000.5, 53600.6. Consistent with  
7 these objectives, state law places strict limitations on the instruments in which local agencies  
8 may invest, as well as the concentration of such investments. For example, treasury investments  
9 are limited, by statute, to conservative instruments such as U.S. Treasury obligations, highly-  
10 rated commercial paper, certificates of deposit, and the like.

11 34. State law also places restrictions upon a city's concentration of investments.  
12 Such restrictions depend on the instruments at issue, as well as the type of local entity making the  
13 purchase. For example, Government Code Section 53601, which applies specifically to local  
14 agencies, authorizes a city to invest up to 10% of fund proceeds into the commercial paper of a  
15 single issuer so long as the issuer has a rating of A-1/P-1/F-1. Section 53601 also allows up to  
16 30% of a city's funds to be invested in "medium term notes," but only 20% of a city's funds to be  
17 invested in money market mutual funds..

## 18 **2. The Structure And Investment Policy Of The City**

19 35. The City has invested its surplus public funds for many years. The funds are used  
20 to finance virtually all services provided by the City, including payroll and purchases.

21 36. The City's investments are governed by the City's Investment Policy, which was  
22 developed and adopted pursuant to Government Code Section 53600-53683. The Investment  
23 Policy sets forth the philosophy for investing the funds, the objectives, the allowable investment  
24 instruments, the maturity and average life of investments, and specific qualifications of the  
25 investments. The Policy sets forth controls relating to investment authority, reporting, auditing,  
26 accounting methods, withdrawal request and other related control matters. Finally, the  
27 Investment Policy sets forth the procedures to be followed in executing investment transactions.

1           37.     In accordance with California law, the Treasurer of the City prepares the Policy  
2 which is reviewed by the Investment Review Committee and ultimately approved by the City  
3 Council.

4           38.     Pursuant to the City's Investment Policy, the responsibility for making  
5 investments resides with the Treasurer who supervises the investment program within the  
6 guidelines of the Policy and state law. The Investment Review Committee meets to evaluate  
7 general strategies and to monitor results and discuss the economic outlook, portfolio  
8 diversification, maturity structure and potential risks. An annual audit is also conducted of the  
9 portfolios, procedures, reports and operations.

10          39.     The investment objectives of the City's Investment Policy are consistent with  
11 state law and can be summarized, in order of priority, as: (1) safety, (2) liquidity and (3) return on  
12 investments.

13          40.     As a result of these statutory mandates, the City has a long history of  
14 maintaining high quality investment portfolios governed by a disciplined investment strategy of  
15 diversification and conservatively designed to achieve a reasonable balance of risk and a stable  
16 source of earnings.

17          41.     Unfortunately, in reliance on Defendants' misrepresentations and omissions,  
18 described in more detail below, the City purchased a substantial interest in a WaMu note which  
19 is now worthless. The note was purchased on or about September 28, 2007, with a maturity date  
20 on June 15, 2011. The par amount of the note was \$5,000,000 with a 6.875% coupon. At the  
21 time, the note was rated A by DBRS, A2 by Moody's, A- by Fitch, and A- by Standard and  
22 Poors. The City made its decision to purchase the WaMu note in California and, at all times,  
23 held the note in its custodial account in California.

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

2           42.     Until its demise, Washington Mutual, Inc. ("WaMu") was one of the largest  
3 savings and loans in the United States. Headquartered in Seattle, Washington, WaMu had a  
4 particularly strong lending and fund raising presence in California. WaMu operated as a savings  
5 and loan holding company with banking subsidiaries and nonbanking subsidiaries. Its banking  
6 subsidiaries included, among others, Washington Mutual Bank, formerly known as Washington  
7 Mutual Bank FA, and Washington Mutual Preferred Funding LLC.

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

15           44.     Within WaMu's Home Loans Group, WaMu's subprime mortgage channel  
16 originated, purchased, and held for investment home loans and home equity loans issued to  
17 subprime borrowers. WaMu originated subprime loans through its subprime division (known for  
18 some time as "Long Beach Mortgage" ("LBM") and known thereafter as the Company's  
19 "specialty mortgage lending" channel) and also purchased loans from subprime lenders. WaMu's  
20 subprime channel was originally part of the Company's Commercial Group, but was moved to  
21 the Home Loans Group in 2006. As of December 31, 2006, WaMu's subprime mortgage channel  
22 loans held for investment totaled \$20.77 billion, of which \$4.40 billion were originated by LBM  
23 and \$16.37 billion were purchased from outside subprime lenders.

24           45.     The primary activities of WaMu's Retail Banking Group included: (1) offering a  
25 comprehensive line of deposit and other retail banking products and services to consumer and  
26 small businesses; (2) holding both the Company's portfolio of home loans held for investment  
27 and the substantial majority of its portfolio of home equity loans and lines of credit (but not the

1 Company's portfolio of mortgage loans originated or purchased through the subprime mortgage  
2 channel); (3) originating home equity loans and lines of credit; and (4) providing investment  
3 advisory and brokerage services, sales of annuities and other financial services.

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

11 47. WaMu originated residential loans through its retail and wholesale lending  
12 operations, which were primarily issued through WaMu's Home Loans and Commercial Groups.  
13 Under the Company's underwriting standards, WaMu purportedly required documentation of the  
14 borrower's credit history and score, income, debt level, and other factors.

15 48. After originating home loans, WaMu either (a) retained the loans as investments  
16 in its "held for investment" portfolio, which generally were reflected as assets in the Company's  
17 public financial reports and in other information disseminated to the public; or (b) held such  
18 loans for sale, and, accordingly, securitized or sold off such loans to third parties in due course,  
19 primarily through the Capital Markets Division of WaMu's Home Loans Group ("WaMu Capital  
20 Corp.").

21 49. WaMu reported significant income from its home lending operations. With  
22 regard to its loans "held for investment," however, WaMu was also required to maintain and  
23 publicly report a reserve amount for probable losses related to such loans (for example, losses  
24 from WaMu borrowers defaulting on their obligations to make mortgage payments). WaMu  
25 referred to its loss reserve as its Allowance for Loan and Lease Losses (the "Allowance").  
26 WaMu's Allowance was one of only five "earnings drivers" that the Company discussed each  
27 quarter, and was a critical metric for investors because, as the Company's 2006 Form 10-K

1 explained, “[t]he [Allowance] represents management’s estimate of incurred credit losses  
2 inherent in the Company’s loan and lease portfolios as of the balance sheet date.” WaMu was  
3 required to periodically reassess and adjust its Allowance, or “provision,” for any such loan and  
4 lease losses. Increases in the Allowance reduced WaMu’s earnings because such charges are  
5 recorded as an expense. Thus, WaMu’s reported Allowance was directly linked to net income  
6 and the Company’s earnings per share.

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

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

14         51. In February 2005, WaMu publicly announced a five-year plan for the Company  
15 which called for “[t]ransforming the company’s mortgage business and maintaining a leading  
16 national position in mortgage lending,” while also “[m]aintaining risk management as a top  
17 priority.”

18         52. The new plan was implemented by WaMu’s senior management, many of whom  
19 held brand new positions at WaMu. For example, Defendant Rotella joined the Company as  
20 President and Chief Operating Officer in January 2005, and became the acting president of the  
21 Home Loans Group in March. In July 2005, Defendant Schneider was appointed as the President  
22 of the Home Loans Group. By the end of 2005, the Company also installed a new Chief  
23 Enterprise Risk Officer, Defendant Cathcart.

24         53. The Company began to promote riskier loan products to both prime borrowers  
25 (borrowers who appeared to be creditworthy) and subprime borrowers, while reducing the share  
26 of traditional, fixed rate loans it originated. The Company focused heavily on originating loan  
27 products, such as WaMu’s “flagship” product, the Option Adjustable Rate Mortgage loan

1 (“Option ARM”), and subprime loans that were “nonconforming,” i.e., they did not meet the  
2 specifications required by the government-sponsored entities (“GSEs”), such as Freddie Mac or  
3 Fannie Mae. Because these nonconforming loans were riskier, WaMu could charge much higher  
4 interest rates and fees for their origination.

5 54. While WaMu acknowledged publicly that it had altered its loan origination mix  
6 in favor of generating more loans with higher profit margins, WaMu and the other Defendants  
7 did not reveal the full extent of WaMu’s highly questionable and unlawful practices directed by  
8 the Individual Defendants to artificially fuel WaMu’s growth targets.

9 55. Option ARMs made up the majority of WaMu’s “prime” mortgage originations,  
10 as well as the majority of the loans in WaMu’s “held for investment” portfolio of loans. Option  
11 ARM loans always made up more than fifty percent of WaMu’s held for investment loan  
12 portfolio and, in the fourth quarter 2006, Option ARM loans comprised \$63.6 billion – or 64% –  
13 of WaMu’s entire \$99.5 billion loan portfolio.

14 56. WaMu’s Option ARM had a minimum payment option based on the interest rate  
15 charged during the introductory period, and was almost always significantly lower than the loan’s  
16 fully-indexed payment rate. The fully-indexed rate was calculated using an index rate plus a  
17 margin. When the introductory or “teaser” period ended, typically after a period of several  
18 months, the contractual interest rate charged on the loan increased to the fully-indexed rate and  
19 adjusted monthly to reflect movements in the index. Moreover, if a WaMu Option ARM  
20 borrower continued to make only a minimum monthly payment after the introductory period  
21 ends, his or her payments often were not sufficient to cover the interest accrued on his or her  
22 loan, resulting in “negative amortization” of the Option ARM loan as unpaid interest is deferred  
23 and added to the loan’s principal balance. WaMu “capped” the amount of negative amortization  
24 on its Option ARM loans from 100% to 125% of the original loan balance. So if a WaMu  
25 borrower reached the negative amortization cap (or at least every 60 months), the borrower’s  
26 WaMu loan was subject to “recasting,” where a new minimum monthly payment is calculated  
27



1 that is sufficient to fully repay the principal balance of the loan, including any deferred interest,  
2 over the remainder of the loan term using the fully-indexed rate then in effect.

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

9 58. The Company falsely represented that it was managing the Company's risk  
10 associated with its Option ARM products by ensuring compliance with appropriate underwriting  
11 standards, monitoring loan performance, and conducting risk modeling procedures. It was not.  
12 For example, although the Company claimed that it did not offer Option ARM loans to subprime  
13 borrowers, WaMu in fact issued Option ARM loans to borrowers with low credit scores  
14 generally considered subprime. Moreover, WaMu underwrote many of its Option ARM loans at  
15 the loan's introductory interest rate, rather than, as represented, at the loan's fully-indexed  
16 interest rate. In other words, WaMu often qualified its Option ARM borrowers based on their  
17 ability to pay temporary, very low "teaser" interest rates rather than the much higher interest rates  
18 that would be in place for the overwhelming majority of the Option ARM loan term.

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

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

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

12           62.     However, soon thereafter, WaMu secretly discontinued appropriate risk  
13 management practices. Even when WaMu's risk management teams identified critical problems  
14 with WaMu's business and accounting practices and brought those matters to the attention of  
15 WaMu's senior management, appropriate remedial actions were not taken.

16           63.     For example, WaMu regularly compiled "Risk Reports" to verify that the  
17 Company as a whole was within guidelines ultimately established by WaMu's Board of  
18 Directors. These reports noted that Company was exceeding certain risk parameters, but were  
19 ignored.

20           64.     WaMu's senior management also encouraged real estate appraisals to be  
21 manipulated so that loans could go through. Appraisers were put under intense pressure to "hit"  
22 higher appraisal values and, if they refused, were not included on "preferred" appraiser lists. As  
23 a result, WaMu originated loans that had artificially low (*i.e.*, favorable) loan-to-value ("LTV")  
24 ratios and loans that otherwise never would have been approved at all.

25           65.     The practice greatly increased the risk to WaMu, and thus, to its noteholders,  
26 such as plaintiff. As explained in WaMu's 2006 Form 10-K: "Credit risk is the risk of loss  
27 arising from . . . the availability and quality of collateral." By misrepresenting the value of  
28

1 underlying loan collateral through manipulating appraisals, WaMu was exposed to a substantial  
2 risk of loss from loans in WaMu's "held for investment" portfolio and to a substantial risk on  
3 loans originated by WaMu and "held for sale" (that is, sold to third parties or securitized), due to  
4 a contingent risk of loss upon the exercise of recourse upon default or the discovered violation of  
5 the representations and warranties, both of which would force WaMu to repurchase such loans.

6         66.       Nonetheless, the Officer Defendants touted the Company's low LTV ratios  
7 concerning the Company's portfolios of loans to reassure investors that the Company was not  
8 taking on an inordinate amount of credit risk. According to Defendant Rotella, the Company's  
9 reported LTV ratios gave the Company a "measure of protection against losses going forward,  
10 because we do have a fair amount of cushion in those portfolios on average."

11         67.       WaMu also under-reserved for loan losses based upon misstated collateral values.  
12 As stated in WaMu's 2006 Form 10-K, "[t]he estimation of the allowance [for loan and lease  
13 losses] is based on a variety of factors, including. . . the estimated value of underlying collateral."

14         68.       Fair and accurate appraisals are of paramount importance to home borrowers  
15 because an appraisal that inflates the value of a borrower's home as too high can cause that  
16 borrower to take a loan in excess of the borrower's actual needs and ability to pay and that is also  
17 unjustified by the market value of the borrower's home. The result of an inflated appraisal,  
18 therefore, is significant additional risk for the borrower – and the lender.

19         69.       Accordingly Federal regulations stress the importance of appraisals:

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

24         12 C.F.R. § 564.8(a) (Emphasis in original.)  
25  
26  
27

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

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

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

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

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

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

21 \* \* \*

22 Typically, borrowers requesting financing with loan-to-value ratios of greater than  
23 80 percent without government guarantees are required to purchase private  
24 mortgage insurance [“PMI”] from a third party. In the event of default, the  
25 Company can recover losses from the private mortgage insurer. Alternatively,  
26 under certain loan programs, qualifying customers can elect to pay a higher  
interest rate to the Company in lieu of paying for private mortgage insurance. This  
higher interest rate is expected to compensate the Company for the incremental  
credit risk inherent in lending to borrowers without private mortgage insurance.

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

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

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

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

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

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

An institution’s appraisal and evaluation program must maintain effective internal  
controls that promote compliance with program standards and the agencies’  
appraisal regulations and Guidelines. Internal controls should, among other

1 criteria, confirm that appraisals and evaluations are reviewed by qualified and  
2 adequately trained individuals who are not involved in the loan production  
processes.

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

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

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

20 79. Thereafter, both eAppraiseIT or LSI received appraisal orders from WaMu, they  
21 were then supposed to select an independent appraiser, provide the necessary information to the  
22 appraiser, and report the impartial results to WaMu once the appraisal was complete. However,  
23 WaMu required that eAppraiseIT and LSI use only appraisers for WaMu loans from a pre-  
24 selected, list created by WaMu sales personnel. In return, eAppraiseIT performed at least  
25 260,000 appraisals for WaMu at a cost of \$50 million.

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

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

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

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

25           84.     However, WaMu abandoned appropriate underwriting standards for its loans  
26 in favor of underwriting policies designed to allow WaMu to increase the volume of loans it  
27 could originate and inflate the Company’s earnings.

1           85.     For example, the Officer Defendants consistently emphasized to the public that  
2 the Company's "prime" loans were of "high quality." At the Company's 2006 Investor Day held  
3 in September 2006, Defendant Cathcart claimed the Company had "maintained conservative  
4 lending standards" in the Company's prime and home equity portfolios that resulted in "high  
5 quality loans."

6           86.     WaMu also regularly distinguished between its "prime" and "subprime" loans.  
7 For example, the Company reported its volumes of prime and subprime mortgage loans produced  
8 and sold, the volumes of prime and subprime loans held for investment, and the value of the  
9 Company's credit-sensitive retained (or "residual") interests in securitized prime and subprime  
10 loans. However, WaMu did not adhere to industry standards for classifying loans.

11           87.     The most widely accepted measure of creditworthiness is the borrower's  
12 Fair Issac Credit Organization ("FICO") credit score. FICO scores are key determinants of  
13 whether a given borrower will be classified as "prime" or "subprime." Fitch Ratings termed  
14 FICO scores the "best single indicator" of mortgage default risk. In its 2005 Amended Form 10-  
15 K, WaMu said that credit scores are "a useful measure for assessing the credit quality of a  
16 borrower" and one of two key determinants "in forecasting future loan performance" (along with  
17 the loan's LTV ratio).

18           88.     A FICO score which can range from 300 to 850, is calculated based on payment  
19 history, amounts owed to creditors, length of credit history, new credit sources, and types of  
20 credit used. Generally, the higher the FICO score, the better the borrower's credit and the lower  
21 the risk of default. According to Fair Isaac, approximately 27% of the U.S. population has a  
22 FICO score between 750 and 799, 27% has a score below 650, and 15% has a score below 600.

23           89.     According to the Expanded Guidance for Subprime Lending Programs, issued  
24 jointly by the Officer of the Comptroller for Currency, the Federal Reserve Board, the Federal  
25 Deposit Insurance Corporation and the Officer of Thrift Supervision on February 2, 2001,  
26 subprime borrowers generally have a FICO score of 660 or below. This Expanded Guidance was  
27 sent to CEOs such as WaMu CEO Defendant Killinger by both the FDIC and the OTS. The  
28 Expanded Guidance lists various credit characteristics of subprime borrowers, including:



1 payment delinquencies, charge-offs, judgments and bankruptcies. Such borrowers “may also  
2 display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other  
3 criteria that may encompass borrowers with incomplete credit histories.” Subprime loans “have  
4 a higher risk of default than loans to prime borrowers.” Accordingly, the Expanded Guidance  
5 states that loans should be classified as subprime in accordance with the guidelines and other  
6 applicable Agency guidelines.

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

16 91. Washington Mutual repeatedly stated that its prime loan borrowers had high FICO  
17 scores. For example, during WaMu’s 2006 Investor Day Conference held on September 7, 2006,  
18 Defendant Cathcart stated that the home equity portfolio, primarily generated through retail  
19 banking channels, has an average FICO score at origination of 734. Defendant Cathcart also said  
20 that the Option ARM loan product, which is “not made available to subprime borrowers,” had a  
21 weighted average FICO score of 708.

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

1           93.       Moreover, because WaMu's Option ARM loans were of particular concern to  
2 investors who wanted to make certain that the Company was not underwriting high-risk loans,  
3 Defendants regularly reassured investors of the strength of the Company's underwriting for  
4 Option ARM loans. In specifically addressing concerns about the Company's Option ARM  
5 portfolio, Defendant Cathcart stated during WaMu's 2006 Investor Day, "At origination, WaMu  
6 focuses on an effective underwriting process and borrower disclosures through our experienced  
7 sales force and broker channels."

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

19           95.       WaMu made loans to "subprime" borrowers through its subprime channel, LBM.  
20 In 2006, LBM was consolidated into the Home Loans Group, and Company's subprime lending  
21 (formerly LBM) was referred to in the Company's SEC filings as WaMu's "specialty mortgage  
22 finance operations." This reorganization did not modify WaMu's subprime lending practices.

23           96.       Although WaMu did not define "subprime" borrowers, subprime loans are  
24 generally made to borrowers with lower FICO scores who could not normally obtain prime loans.  
25 Because subprime borrowers' credit scores indicated that they were less creditworthy than  
26 WaMu's "prime" borrowers, WaMu was able to charge much higher interest rates and fees on  
27 these subprime loans. However, WaMu also assured investors that although loans were being  
28 made to borrowers with low FICO scores, the Company's purportedly rigorous underwriting

1 standards guarded against excessive credit risk to the Company. For example, the Company's  
2 Amended 2005 Form 10-K announced that, "[t]he Company seeks to mitigate the credit risk in  
3 [WaMu's subprime] portfolio by ensuring compliance with underwriting standards on loans  
4 originated to subprime borrowers and by re-underwriting all purchased subprime loans." As set  
5 forth below, WaMu made a similar reassurance in its 2006 Form 10-K.

6 97. Furthermore, in July 2006, Defendant Rotella claimed that with regard to the  
7 Company's subprime lending, "we're being quite careful and making any changes we need to  
8 make in our credit policies as we move forward, but our sense of things are – things are in pretty  
9 good shape." At WaMu's 2006 Investor Day, in September 2006, Defendant Schneider claimed  
10 that:

11 On subprime, we have seen, as others have seen, some early payment default and  
12 repurchase activity. We saw most of that occur for us in late '05, Q4 '05, and first  
13 quarter of '06. We reserved for it appropriately and we have also, in second  
14 quarter of '06, tightened up a number of our underwriting guidelines, and you  
15 can see that in our numbers.

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

20 98. The FDIC issued specific warnings regarding subprime lending to mortgage  
21 lenders. For example, in 1999, the Office of the Comptroller of the Currency, the Federal  
22 Reserve Board, the Federal Deposit Insurance Corporation, and the OTS jointly issued the  
23 Interagency Guidance on Subprime Lending, which gave extensive guidance to subprime lenders  
24 regarding risk management and appropriate credit loss reserving. The guidance noted, "If the  
25 risks associated with this activity are not properly controlled, the agencies consider subprime  
26 lending a high risk activity that is unsafe and unsound."

27 99. However, as discussed above, the Individual Defendants failed to implement or  
28 enforce subprime lending guidelines, allowing WaMu employees to consummate more and more  
subprime loans.

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

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

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

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

17           103. Indeed, the Company’s 2006 Form 10-K explained, “[t]he [Allowance] represents  
18 management’s estimate of incurred credit losses inherent in the Company’s loan and lease  
19 portfolios as of the balance sheet date.” Not surprisingly, the Officer Defendants consistently  
20 touted the soundness of WaMu’s Allowance. For example, during a May 18, 2006 conference  
21 call, Defendant Killinger announced: “The next target is on the credit front. . . . Certainly we can  
22 come back in the Q&A if you want to talk more about credit; but credit for us is [in] excellent  
23 shape, and I feel very comfortable with where we are from management of that credit as well as  
24 the reserving.”

25           104. The Allowance was reported on the Company’s balance sheet as a reduction to  
26 assets. As loans were “charged off” as losses against the Allowance, the Allowance was reduced.  
27 In order to properly account for the worsening credit quality of its loan portfolio, WaMu was  
28 required under GAAP to record periodic provisions (which WaMu referred to as its “provisions

1 for loan and lease losses” or its “provision for loan losses”) to increase its reserve to reflect its  
2 estimate of incurred or probable credit losses. Under GAAP, a provision for loan and lease  
3 losses is recorded as an expense, which reduces pre-tax earnings on a dollar-for-dollar basis.  
4 Thus, WaMu’s reported Allowance was directly linked to net income and the Company’s  
5 earnings per share.

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

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

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

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

24 (Emphasis in original.)

25 107. In the context of lending, Statement of Financial Accounting Standards No. 114,  
26 “Accounting By Creditors for Impairment of a Loan” (“SFAS 114”), which was issued in May  
27 1993 – over fifteen years ago – provides a definition of “impairment” for individual loans under  
28 GAAP that is also instructive for pooled loans: “A loan is impaired when, based on current  
information and events, it is probable that a creditor will be unable to collect all amounts due  
according to the contractual terms of the loan agreement.”

1           108. Further, the American Institute of Certified Public Accountants' (AICPA) *Audit*  
2 *and Accounting Guide for Depository and Lending Institutions: Banks and Savings Institutions,*  
3 *Credit Unions, Finance Companies and Mortgage Companies* (the "AICPA Guide"), which was  
4 originally issued in 2004 and updated in 2007, states: "if a faulty credit granting decision has  
5 been made or loan credit review procedures are inadequate or overly aggressive . . . the loss  
6 should be recognized at the date of loan origination."

7           109. These fundamental GAAP provisions underpin the "Expanded Guidance for  
8 Subprime Lending Programs," issued by the Agencies in 2001, which provided guidance specific  
9 to reserving for subprime loans:

10           The [Allowance] required for subprime loans should be sufficient to absorb at  
11           least all estimated credit losses on outstanding balances over the current operating  
12           cycle, typically 12 months. The board of directors and management are  
13           expected to ensure that the institution's process for determining an adequate  
14           level for the [Allowance] is based on a comprehensive and adequately  
15           documented analysis of all significant factors. The consideration of factors  
16           should include historical loss experience, ratio analysis, peer group analysis,  
17           and other quantitative analysis, as a basis for the reasonableness of the  
18           [Allowance]. To the extent that the historical net charge-off rate is used to  
19           estimate expected credit losses, it should be adjusted for changes in trends,  
20           conditions, and other relevant factors, including business volume, underwriting,  
21           risk selection, account management practices, and current economic or business  
22           conditions that may alter such experience. The allowance should represent a  
23           prudent, conservative estimate of losses that allows a reasonable margin for  
24           imprecision.

25           110. The SEC also provides direct guidance on the proper accounting for loan losses.  
26           SEC Staff Accounting Bulletin No. 102, "Selected Loan Loss Allowance Methodology and  
27           Documentation Issues" ("SAB 102"), which was issued in July 2001, states in pertinent part: "It  
28           is critical that loan loss allowance methodologies incorporate management's current judgments  
29           about the credit quality of the loan portfolio through a disciplined and consistently applied  
30           process." Therefore, pursuant to SAB 102, a loan loss allowance methodology generally should  
31           "[c]onsider all known relevant internal and external factors that may affect loan collectability . . .  
32           [and] be based on current and reliable data[.]" The Officer Defendants failed to appropriately  
33           take into account these factors in provisioning for the Company's Allowance.

34           111. The SEC further states in SAB 102 that "[f]or many entities engaged in lending  
35           activities, the allowance and provision for loan losses are significant elements of the financial

1 statements. Therefore, the staff believes it is appropriate for an entity's management to review,  
2 on a periodic basis, its methodology for determining its allowance for loan losses." Thus, in  
3 addition to evaluating loans for impairment at origination, lenders are expected to reevaluate  
4 their reserving methodology and loan portfolios for impairment every financial reporting period.

5 112. WaMu, Deloitte, and the Officer Defendants concealed their material deviations  
6 from these accounting standards and falsely described the Company's Allowance. WaMu  
7 represented that it was following appropriate accounting rules and that, among other things, the  
8 Company's management reviewed its models for loan losses for reasonableness, and, on a  
9 quarterly basis, updated the assumptions used in those models. In addition, according to the  
10 Company's 2006 Form 10-K, WaMu supposedly evaluated for impairment its loans held in  
11 portfolio on a collective basis "using statistical forecasting models that estimate default and loss  
12 outcomes based on an evaluation of past performance of loans in the Company's portfolio and  
13 other factors as well as industry historical loan loss data." Based on this statistical modeling, the  
14 Company represented, WaMu allocated a certain percentage of its provision for loan losses to its  
15 different loan product categories (*e.g.*, home loans, credit card loans, commercial loans).

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

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

26 114. According to the Company's 2006 Form 10-K, the Finance Committee of  
27 the Company's Board of Directors oversaw the Company's credit risk management activities,  
28 including Defendants Frank and Reed. Further, according to the Company's 2006 Form 10-K,

1 the Company's Enterprise Risk Management Committee, which was chaired by the Company's  
2 Chief Enterprise Risk Officer, Defendant Cathcart, was responsible for "oversee[ing] the  
3 identification, measurement, monitoring, control and reporting of credit, market and operational  
4 risks." The Company's 2006 Form 10-K explained that:

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

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

10       115. The deterioration of the credit quality of WaMu's loans was neither outside of the  
11 Company's control nor was it unforeseeable to management. Indeed, WaMu increasingly  
12 underwrote high-risk loans with loose underwriting standards and inflated appraisals, which it  
13 knew were impaired, while under-provisioning its Allowance. For example, the Company  
14 increased the proportion of Option ARM loans in its home loan portfolio without adjusting its  
15 Allowance appropriately. Indeed, the Company encouraged its salespeople and mortgage brokers  
16 with whom the Company worked to sell ever greater numbers of Option ARM loans through  
17 bonus incentives. Option ARM loans dominated WaMu's single-family residential portfolio.

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

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

26       118. Similarly, the Officer Defendants did not adequately consider the Company's  
27 "levels of and trends in delinquencies and impaired loans" in provisioning for loan losses. The  
28 quality of the Company's loan portfolio was steadily worsening over time, illustrated by the



1 rising number of “nonaccrual loans,” or home mortgage loans that were over ninety days past due  
2 on payments. Instead of increasing the Allowance in compliance with GAAP to properly account  
3 for the deteriorating quality of WaMu’s loan portfolio, the Officer Defendants actually decreased  
4 the Allowance relative to the number of nonaccrual loans that were accumulating in the  
5 Company’s portfolio, after taking into account one-time events, such as Hurricane Katrina-  
6 related costs.

7 **D. 2007: In Midst Of Defendants’ Reassurances To Market About WaMu’s**  
8 **Financial Condition And Risk Management Practices, The City Purchases**  
9 **Interest In WaMu Note**

10 119. On January 17, 2007, WaMu issued a press release announcing its financial  
11 results for the quarter and year-ended December 31, 2006. WaMu reported that, for the fourth  
12 quarter 2006, the Company had a net income of \$1.06 billion, compared with net income of \$865  
13 million in the fourth quarter of 2005. For the full year 2006, the Company’s reported net income  
14 was \$3.56 billion, compared with a net income of \$3.43 billion, in 2005. WaMu also reported  
15 that its provision for loan and lease losses for the fourth quarter 2006 was \$344 million, \$95  
16 million of which the Company attributed to the Company’s on balance sheet credit card  
17 receivables. For the full-year 2006, the Company reported a loan loss provision of \$816 million,  
18 an increase of \$500 million over 2005, which the Company stated in its earnings release was  
19 “primarily due to the addition of the company’s credit card business acquired Oct. 1, 2005.”  
20 Defendant Killinger stated that the Company’s “outlook for 2007 reflects the strategic actions we  
21 took in 2006 to prepare the company for the future. Those decisive actions have positioned us  
22 well to deliver stronger operating performance in 2007.”

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

27 As you’ll recall I have been pretty pessimistic on the housing market for the last  
28 couple of years, and really felt that the market was overheated and was likely to  
be slowing at some point, and so both the combination of that and also from a  
strategic standpoint we’ve been diversifying our mix of businesses . . . We  
tightened underwriting, we decreased production volume by about half in the

1 subprime area taking ourselves down from the sixth largest originator all the way  
2 down to ten, and we decreased the subprime portfolio you were asking about by  
3 about \$2.4 billion over the last twelve months, and I think the important thing is  
4 that as the housing market has softened as expected, what I have really seen is a  
5 continued very good performance out of most parts of the portfolio.

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

11 121. On January 30, 2007, Defendant Killinger appeared at the Citigroup 2007  
12 Financial Services Conference and told investors that the credit quality of the Company’s loan  
13 portfolio “continue[d] to be in very good shape.” Killinger noted the “high quality” of the  
14 Company’s prime loans, the “very good” quality of the Option ARM portfolio, and the “very  
15 high quality” of the home equity portfolio. Killinger then attributed the high credit quality of  
16 these loans to the low LTV ratios associated with those loan portfolios. Killinger underscored  
17 the Company’s “rigorous adher[ence] to [its] minimum FICO threshold” in its subprime portfolio  
18 and, in response to a question regarding the Company’s charge-offs in its subprime portfolio,  
19 downplayed the importance of the charge-offs, explaining that the Company’s subprime portfolio  
20 had been decreasing in size and claiming that “when you’re not originating new ones at the same  
21 level and are letting the portfolio run up, you get a natural increase in [charge offs].”

22 122. On March 1, 2007, WaMu filed with the SEC a Form 10-K for the fourth  
23 quarter and fiscal year ended December 31, 2006 (the “2006 Form 10-K”). The 2006 Form 10-K  
24 was signed by Defendants Killinger, Casey, Frank, Leppert, Reed, Smith, Matthews, and  
25 Murphy, amongst others, and included Deloitte’s unqualified audit opinion on the Company’s  
26 financial statements and management’s assessment of internal controls. Specifically, Deloitte  
27 stated:

28 In our opinion, such consolidated financial statements present fairly, in all  
material respects, the financial position of the Company as of December 31, 2006  
and 2005, and the results of operations and of its cash flows for each of the three  
years in the period ended December 31, 2006, in conformity with accounting  
principles generally accepted in the United States of America. We have also

1 audited, in accordance with the standards of the PCAOB, the effectiveness of the  
2 Company's internal control over financial reporting as of December 31, 2006 . . .  
3 and our report dated February 26, 2007, expressed an unqualified opinion on  
4 management's assessment of the effectiveness of the Company's internal control  
5 over financial reporting and an unqualified opinion on the effectiveness of the  
6 Company's internal control over financial reporting.

7 The Company reiterated the financial results set forth in the January 17, 2007 press release and  
8 earnings call, and also reported a full-year provision for loan and lease of \$816 million in 2006,  
9 compared with a provision of \$316 million in 2005. According to the 2006 Form 10-K, this  
10 higher provision was "substantially the result of the Company's entry into credit card lending that  
11 resulted from the Providian acquisition and the ensuing growth in the on-balance sheet credit  
12 card portfolio, which accelerated during the fourth quarter of 2006." WaMu also touted the  
13 Company's underwriting standards for its Option ARM portfolio, claiming that, "[t]he Company  
14 actively manages the credit risk inherent in its Option ARM portfolio primarily by ensuring  
15 compliance with its underwriting standards, monitoring loan performance and conducting risk  
16 modeling procedures." The Company announced improved credit risk management practices,  
17 stating: "In 2006, the Finance Committee of the Board of Directors approved a set of credit risk  
18 concentration limits. These limits facilitate a more rigorous and quantitative framework that  
19 better enables the credit risk management function to proactively manage credit risk."  
20 Defendants Killinger and Casey signed certifications attesting to the accuracy of the information  
21 contained in the 2006 Form 10-K, and the Form 10-K contained a statement confirming the  
22 adequacy of the Company's internal controls over financial reporting.

23 123. Analysts and bond rating agencies alike responded favorably to the Company's  
24 and Deloitte's statements regarding the Company's financial condition, credit quality and internal  
25 controls. Although all analysts noted the difficult mortgage environment in which the Company  
26 operated, the Officer Defendants' reassurances that the Company had prepared for these negative  
27 events by tightening underwriting practices were well-received. For example, Erin Swanson of  
28 Morningstar observed that "all is not smooth sailing" given the "softening" in the industry;  
however, "[t]hat said, we think WaMu's management team anticipated this slowdown and began  
taking steps to position its balance sheet for tougher times. During 2006, WaMu sold all of its

1 subprime mortgage originations, tightened its underwriting, and reduced its subprime portfolio  
2 by \$2.4 billion.” Swanson raised the fair value estimate of WaMu by \$5 a share. The Company’s  
3 stock price also rose from a close of \$44.06 on January 16, 2007, to close at \$45.35 on January  
4 24, 2007, an increase of almost 3%.

5 124. On April 17, 2007, WaMu issued a press release announcing its financial results  
6 for the quarter ending March 31, 2007, including net income of \$784 million, and total assets of  
7 \$319.9 billion. In the press release, Defendant Killinger praised the Company’s performance,  
8 stating, “[o]verall, we delivered solid results in the first quarter despite the challenging interest  
9 rate environment and slowing housing market.” The Company also reported that its provision for  
10 loan and lease losses was \$234 million, down from to \$344 million in the fourth quarter 2006.  
11 The Company noted that although the subprime portfolio had deteriorated, the prime portfolio  
12 had improved. During an earnings call that same day, Defendant Killinger stated:

13 “While we’re not at our full earnings potential, I am pleased with the solid results  
14 delivered by our team, despite a quarter that was challenged by a number of  
15 environmental factors. We had an inverted yield curve, and slowing housing  
16 markets and unprecedented deterioration in the subprime mortgage business. . . .  
17 In home loans, which felt the brunt of the environmental challenges during the  
18 quarter, we were encouraged by improved performance in our prime lending  
19 business. . . . reflecting these results and the company’s strong financial position,  
20 the Board once again increased the quarterly cash dividend, for the 47th  
21 consecutive quarter, by \$0.01, to \$0.55 cents per share. . . . [The Company is]  
22 seeing encouraging signs with the improvement in the prime business that we saw  
in the first quarter, and with the steps that we’ve taken into the subprime area of  
increasing pricing, improving underwriting, that we are starting to see that show  
up in the way of early signs of credit on the 2007 production looks much better  
than ‘06, so that’s encouraging. . . . I would view the first quarter of having been  
profitable for our prime part of the business. It was offset[,] more than offset[,] by  
the losses in the subprime area, and as the subprime area comes back to more of a  
normalcy, I think that we can certainly expect the home loan unit to get back to  
profitability and the current expectation for us is later in the year, rather than  
getting specific on one quarter or the other.”

23 Similarly, Defendant Casey again highlighted the improved standards supposedly imposed  
24 on the Company’s subprime channel, stating “With regard to pricing and underwriting standards  
25 in the subprime area, as Kerry mentioned, we’ve been working on this for quite some time.  
26 We’ve reduced our volume significantly and in the first quarter, we have significantly increased  
27 our pricing and decreased our risk profile that we’re willing to underwrite to, and so we think  
28 all those factors taken together will make this business a little more profitable. We are being

1 selective with our underwriting.” Defendant Rotella stated: “we have absolutely no  
2 plans to shut down our subprime channel. We have, as you’ve heard, since the beginning of last  
3 year been tightening credit in that part of our business. You heard the volume numbers were  
4 down 51% year on year and volume and we feel pretty good about the credit box we’re playing  
5 in right now, but we’re cautious as the market goes through this rationalization.”

6 125. On May 10, 2007, the Company filed with the SEC a Form 10-Q for the  
7 period ending March 31, 2007, which was signed by Defendant Casey (the “First Quarter 2007  
8 Form 10-Q”). The First Quarter 2007 Form 10-Q repeated the financial results set forth in the  
9 Company’s April 17, 2007 press release and earnings conference call, and also stated that “[t]he  
10 Company’s financial reporting and accounting policies conform to accounting principles  
11 generally accepted in the United States of America (‘GAAP’).” Defendants Killinger and Casey  
12 signed certifications attesting to the accuracy of the information contained in the First Quarter  
13 2007 Form 10-Q. Additionally, the First Quarter 2007 Form 10-Q contained a statement  
14 confirming the adequacy of the Company’s internal controls over financial reporting. The First  
15 Quarter 2007 Form 10-Q again reiterated the Company’s stated belief that “loan-to-value ratios  
16 are one of the two key determinants in determining future loan performance.” In response, the  
17 Company’s stock price rose from a close of \$40.73 on April 16, 2007, to close at \$42.77 on April  
18 20, 2007, an increase of 5%.

19 126. On July 18, 2007, WaMu issued a press release announcing its financial results  
20 for the quarter ending June 30, 2007, reporting that, for the second quarter 2007, the Company  
21 had net income of \$830 million, and total assets of \$312.2 billion. Defendant Killinger praised  
22 the performance, stating, “We delivered record growth in our retail banking, credit card and  
23 commercials businesses during the second quarter. Our Home Loans’ results improved from the  
24 first quarter and we are targeting a return to profitability by the end of the year.” The Company  
25 also reported that its provision for loan and lease losses was \$372 million, up from \$234 million  
26 in the second quarter 2007. The Company noted that the performance of the Company’s home  
27 loans portfolio had improved over the second quarter, stating that “Home Loans shows  
28 improvement in a difficult environment,” and “Prime business continues to improve.”

1 That same day, the Company held an earnings call and Defendant Killinger announced, “We  
2 also saw improvement in the performance of our home loans group, despite continued pressure  
3 from the challenging rate environment and ongoing weakness in the subprime mortgage market  
4 as well as continued erosion in the housing market.” Defendant Casey stated, “While we  
5 anticipate that we will see higher [nonperforming assets] across all of our home loan portfolios,  
6 we expect losses in the prime loans to be much lower due to the lower LTVs and high FICO  
7 profile of our prime portfolio.” Defendant Killinger touted the Company’s role in the industry  
8 with regard to underwriting standards, stating:

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

19 127. On August 9, 2007, the Company filed with the SEC a Form 10-Q for the  
20 period ending June 30, 2007, which was signed by Defendant Casey (the “Second Quarter 2007  
21 Form 10-Q”). The Second Quarter 2007 Form 10-Q repeated the financial results set forth in the  
22 Company’s July 18, 2007 press release and earnings conference call and stated that “[t]he  
23 Company’s financial reporting and accounting policies conform to accounting principles  
24 generally accepted in the United States of America (“GAAP”).” Defendants Killinger and Casey  
25 signed certifications attesting to the accuracy of the information contained in the Second Quarter  
26 2007 Form 10-Q. Additionally, the Second Quarter 2007 Form 10-Q contained a statement  
27 confirming the adequacy of the Company’s internal controls over financial reporting.

1           128. On September 10, 2007, Defendants Killinger and Casey attended the WaMu  
2 Brothers 5th Annual Financial Services Conference. Defendant Killinger continued to falsely  
3 assure investors that for “over two years” the Company had been taking “proactive steps” to  
4 prepare for a decline in housing prices, including “a series of major underwriting changes in our  
5 home loans lending guidelines.” Defendant Killinger also touted the Company’s low LTV ratios  
6 in its home loan portfolio and the “attractive” returns seen on Option ARM loans and other  
7 adjustable rate mortgages, noting that “the credit quality in these loans is good.” However,  
8 Killinger revealed that, while he was not updating the Company’s guidance, the Company  
9 anticipated that the provision for loan losses for 2007 “could be approximately \$500 million  
10 greater” than the full year guidance the Company provided in July 2007 (\$1.5 billion to \$1.7  
11 billion). Defendant Killinger attributed this to a “near perfect storm” in housing conditions and  
12 rising interest rates. Killinger reassured investors that WaMu was taking “proactive steps” and  
13 that general conditions were to blame for the Company’s anticipated heightened provision for  
14 loan and lease losses. In response, WaMu’s stock price rose from a closing price of \$34.74 per  
15 share on September 10, 2007 to a closing price of \$38.32 per share on September 19, 2007.

16           129. On or about September 28, 2007, in reliance on Defendants’ misrepresentations  
17 and omissions, the City purchased a substantial interest in a WaMu note, with a maturity date on  
18 June 15, 2011. The par amount of the note was \$5,000,000.00 with a 6.875% coupon and a  
19 purchase price of 103.700. At the time of purchase, the note was rated A by DBRS, A2 by  
20 Moody’s, A- by Fitch, and A- by Standard and Poors. The City made its decision to purchase the  
21 WaMu note in California and, at all times, held the note in its custodial account in California.

22           130. On October 5, 2007, the Company issued a press release entitled “Washington  
23 Mutual Q3 Net Income Impacted by Market and Credit Environments,” including the Company’s  
24 third quarter 2007 results. WaMu disclosed that the Company’s net income for the quarter would  
25 decline by approximately 75% from the same quarter during the prior year due to “a weakening  
26 housing market and disruptions in the secondary market.” WaMu also said the Company’s loan  
27 loss provision for the third quarter was expected to increase to approximately \$975 million due to  
28 “ongoing weakness in the housing market, primarily as it affects subprime and home equity

1 loans, as well as growth in the company's loan portfolio." Nonetheless, Killinger reassured  
2 investors about the Company's financial position, explaining that WaMu expected improved  
3 results the following quarter: "While we're disappointed with our anticipated third quarter  
4 results, we look forward to an improved fourth quarter as we continue to see good operating  
5 performance in our Retail Banking, Card Services and Commercial Group businesses." Based on  
6 Killinger's assurances, WaMu's stock price rose from \$35.06 per share on October 5, 2007 to  
7 \$35.61 per share on October 8, 2007. Similarly, WaMu's note prices continued to climb. The  
8 purchase price of the City's note reached a high of 105.341 on October 24, 2007.

9 131. On November 9, 2007, the Company filed with the SEC a Form 10-Q for the  
10 quarter ended September 30, 2007 (the "Third Quarter 2007 Form 10-Q"), which was signed by  
11 Defendant Casey and included certifications by Defendants Killinger and Casey. The Third  
12 Quarter 2007 Form 10-Q repeated the financial results set forth in the Company's October 17,  
13 2007 press release, including that the Company's provision for loan and lease losses was \$967  
14 million for the quarter. The Third Quarter 2007 Form 10-Q continued to conceal the Company's  
15 improper lending, and accounting practices and deficient risk management. It also failed to  
16 disclose the true extent of the Company's loss exposure.

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

25 133. On February 29, 2008, the Company filed with the SEC its Form 10-K for the  
26 year ended December 31, 2007, which was signed by, among others, Defendants Killinger and  
27 Casey, and included certifications by Defendants Killinger and Casey. On May 22, 2008, the  
28 Company filed with the SEC its Form 10-K/A for the year ended December 31, 2007



1 (collectively, the “2007 Form 10-K”). The 2007 Form 10-K repeated the financial results set  
2 forth in the Company’s January 17 press release, and continued to conceal the Company’s  
3 improper lending, and accounting practices and deficient risk management practices as well as  
4 the true extent of the Company’s loss exposure.

5 134. On March 14, 2008, Moody’s downgraded the Company’s senior unsecured debt  
6 rating from Baa2 to Baa3, one level above junk status. In lowering its rating, Moody’s explained  
7 that it “believes that remaining lifetime losses on [WaMu’s residential mortgage loan] portfolio  
8 will be higher than previously expected” and that “WaMu’s required provisioning is likely to be  
9 greater than \$12 billion and that full year 2008 net losses could eliminate the company’s  
10 approximately \$6 billion capital cushion above regulatory well capitalized minimums.” Moody’s  
11 also placed a negative outlook on all WaMu entities.

12 135. On April 7, 2008, private equity firm TPG reportedly was close to a deal to invest  
13 \$5 billion in WaMu in order for WaMu’s to alleviate its pressing capital requirements. After the  
14 close of the market on April 7, additional reports circulated that WaMu was exiting its wholesale  
15 lending business.

16 136. On April 8, 2008, the Company announced its first quarter 2008 results, including  
17 a net loss of \$1.1 billion. The quarterly dividend was reduced from \$0.15 to \$0.01. The  
18 Company also disclosed that the loan loss provision increased to \$3.5 billion, almost double what  
19 the Company stated it would be on December 10, 2007. The Company also stated that it was  
20 closing all 186 of its stand-alone home loan offices nationwide and eliminating approximately  
21 3,000 jobs as part of the closings. The Company also announced that it would raise \$7 billion in  
22 capital through a direct sale of equity securities to an investment vehicle managed by TPG  
23 Capital.

24 137. On April 11, 2008, Goldman Sachs issued a report, recommending that  
25 its clients short-sell WaMu stock because it estimated that WaMu has “\$17 to \$23 billion of  
26 embedded losses in its current book of business” and forecasted “a “\$14b provision charge in  
27 2008.” Goldman Sachs further estimated that WaMu may lose \$3.30 per share in 2008.

1           138. On April 16, 2008, Chris Brendler of Stifel Nicolaus issued a report and  
2 questioned the Company's ability to return to profitability, observing, "as [management]  
3 struggles to right the sinking ship, we are increasingly questioning the value of [WaMu]'s  
4 remaining franchise. The home loan business is broken, the loan portfolio is a disaster. . . ."

5           139. On April 29, 2008, WaMu announced that Defendant Cathcart had left the  
6 Company.

7           140. On May 12, 2008, WaMu the filed with the SEC its Form 10-Q for the quarter  
8 ended March 31, 2008 (the "First Quarter 2008 Form 10-Q"), which was signed by Defendants  
9 and Casey and included certifications by Defendants Killinger and Casey. The First  
10 Quarter 2008 Form 10-Q repeated the financial results set forth in the Company's April 8, 2008  
11 press release. The First Quarter 2008 Form 10-Q continued to conceal the Company's improper  
12 lending and, accounting practices and deficient risk management as well as the true extent of the  
13 Company's loss exposure.

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

17           142. On June 9, 2008, UBS Investment Research published a detailed analyst report on  
18 WaMu, concluding, that cumulative losses on WaMu's mortgage portfolio will likely total close  
19 to \$21.7 billion through 2011, between 12.5 to 44% greater than the loss guidance of \$12 to \$19  
20 billion that the Company provided to the market in April 2008. Moreover, with respect to its  
21 \$21.7 billion loss estimate, UBS observed that it might still be too low, stating: "The attributes of  
22 WM's remaining loan portfolio and broader economic weakening mean our bias is that losses  
23 could be worse than our projection." This report also estimated that WaMu would record \$24.2-  
24 \$24.7 billion in incremental loan loss provisions between now and 2010.

25           143. After the close of the market on July 14, 2008, WaMu issued a press release,  
26 claiming that the Company's was sufficiently capitalized and had excess liquidity of more than  
27 \$40 billion. As a result of this press release, the market price of WaMu's stock rebounded  
28 slightly, rising to \$5.92 per share in the days following this announcement.

1           144.    Yet, just ten days later, after the markets closed on July 22, 2008, WaMu  
2 announced its second quarter 2008 financial results, revealing that the Company suffered a net  
3 loss of \$3.3 billion, more than 65% greater than the Company's first quarter 2008 net loss of  
4 \$1.14 billion, driven by a significant increase in its loan loss reserves. The Company further  
5 announced that it increased its loan loss reserves by \$3.74 billion to \$8.46 billion and that it took  
6 a \$5.9 billion loan loss provision in the quarter, an increase of 40% from the \$3.5 billion  
7 provision that the Company recorded in the first quarter 2008. The Company explained:  
8 "approximately one third of the second quarter provision for loan losses related to significant  
9 changes in key assumptions the company used to estimate incurred losses in its loan portfolio."  
10 Specifically, the Company shortened the time period used to evaluate defaults for its prime  
11 mortgage portfolio to one year from three years "to reflect the evolving risk profile of the loan  
12 portfolio and adjusted its severity assumptions for all single family mortgages to reflect the  
13 continuing decline in home prices." In addition, WaMu announced that its unpaid mortgages,  
14 foreclosed homes and other nonperforming assets continued to increase during the second  
15 quarter.

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

23           146.    The market reacted swiftly to this news, driving down the stock price 20% from a  
24 closing price of \$5.82 per share on July 22, 2008 to a closing price of \$4.65 per share on July 23,  
25 2008. Dominion Bond Rating Service Limited and Standard & Poor's downgraded  
26 WaMu's bond ratings. Moody's placed WaMu and its bank subsidiary on review for a  
27 downgrade to junk status. Piper Jaffray downgraded WaMu to "Sell" and Merrill Lynch cut the  
28 Company's rating to "Underperform."

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

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

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

11 150. The City, and the thousands of residents it includes, have been left in the  
12 disastrous wake. The City's note is now in default.

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

14 151. Deloitte served as WaMu's outside auditor for years, including throughout the  
15 relevant period. WaMu retained Deloitte to conduct quarterly reviews of its interim financial  
16 results and to conduct the annual audit of the Company's fiscal results, including for fiscal years  
17 ending in 2005 and 2006. As the "independent" auditor, Deloitte was responsible for conducting  
18 audits on WaMu's financial statements and issuing audit reports, knowing that they would be  
19 used and relied upon by prospective and existing investors of WaMu, as well as analysts, in  
20 evaluating the purchase and holding of WaMu securities. Indeed, the reports were specifically  
21 addressed to WaMu's stockholders. Thus, the City was an intended beneficiary of Deloitte's  
22 audit reports.

23 152. By virtue of its long history with WaMu, Deloitte was intimately familiar with  
24 WaMu's business model, its employees, its products, and its increasing exposure by virtue of its  
25 loan practices. Moreover, in the course of its work, including its audit planning procedures for  
26 the audits, Deloitte reviewed WaMu's internal controls, paying specific attention to loan  
27 practices, real estate loan valuations and risk exposure. Deloitte audited large transactions and  
28 received from WaMu numerous materials concerning those transactions. Deloitte participated in

1 drafting and reviewing WaMu's quarterly press releases, which announced WaMu's  
2 performance, financial condition, asset valuations and revenues. Deloitte reviewed drafts of  
3 WaMu's filings with the SEC prior to filing. Deloitte also attended and made presentations at  
4 Board of Director and Committee meetings, where it discussed the results of its examination of  
5 WaMu's financial statements.

6 153. With respect to its audit work, Deloitte provided "clean" audit opinions included  
7 in WaMu's Form 10-K for 2005, 2006 and 2007, confirming that Deloitte had conducted its audit  
8 in accordance with GAAS and that based on its review, WaMu's financial statements fairly  
9 presented the Company's financial position for fiscal years 2005, 2006 and 2007, in accordance  
10 with GAAP.

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

16 155. Deloitte was also well aware that investors, like the City, were relying on it to  
17 investigate and confirm that WaMu's financial condition was accurately reported. Deloitte  
18 promoted itself as one of the foremost accounting firms in the world, with special experience in  
19 real estate and sophistication in accounting for complex capital markets. Deloitte also promoted  
20 its multi-disciplinary business to address the particular risks for audit clients engaged in real  
21 estate, combining the skills of audit, tax, advisory and valuation professionals.

22 156. Similarly, Deloitte recognized that prospective and existing investors in WaMu,  
23 like the City, were the intended beneficiaries of its work.

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

1 By certifying the public reports that collectively depict a corporation's financial status,  
2 the independent auditor assumes a **public responsibility transcending any employment**  
3 **relationship with the client**. The independent public accountant performing this special  
4 function owes **ultimate allegiance to the corporation's creditors and stockholders, as**  
5 **well as the investing public**. This "public watchdog" function demands that the  
6 accountant maintain total independence from the client at all times and requires  
7 complete fidelity to the public trust. To insulate from disclosure a certified public  
8 accountant's interpretations of the client's financial statements would be to ignore the  
9 significance of the accountant's role as a disinterested analyst charges with public  
10 obligations.

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

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

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

25 160. However, contrary to its public statements and its professional duties to WaMu's  
26 investors, Deloitte failed to design or perform its audit in a manner to account for these audit  
27 risks, and therefore was unable to provide unqualified opinions regarding WaMu's financial  
28 statements.

1 The entire purpose of an audit is to obtain an opinion that the financial statements  
2 fairly present, in all material respects, the financial position of the company in conformity with  
3 accounting principles generally accepted in the United States ("GAAP"). These principles are  
4 further clarified by Statements on Auditing Standards ("SAS") that are referred to with an "AU"

1 number. The auditor has the affirmative duty to plan and perform the audit to obtain *reasonable*  
2 *assurance* that the financial statements are free of material misstatement, whether caused by  
3 error or fraud. AU 110.02.

4 162. To obtain such reasonable assurance, the independent auditor has to perform  
5 specific procedures called for by GAAS and, after performing such procedures, determine if  
6 anything came to his or her attention that would lead them to believe that the financial statements  
7 were not fairly presented in accordance with GAAP. AU 722.09. Indeed, the audit process  
8 *requires professional skepticism* in order to properly test management's representations so that  
9 the auditor actually has a reasonable basis on which to form an opinion regarding the financial  
10 statements. AU 333.02. The audit opinion is valuable precisely because the auditor is  
11 supposedly conducting an *independent* and *skeptical* examination of the information provided by  
12 management.

13 163. Thus, the auditor must consider both audit risk and materiality in (1) planning the  
14 audit and designing audit procedures, and (2) in evaluating the results of the audit in relation to  
15 the financial statements as a whole. AU 312.12. The auditor must plan the audit to obtain  
16 reasonable assurance of detecting material misstatements that it believes could be large enough,  
17 individually or in the aggregate, to be quantitatively material to the financial statements. AU  
18 312.20.

19 164. Deloitte failed to adhere to these basic accounting principles. As a result, its audit  
20 reports misrepresented the true financial condition of WaMu and misrepresented that it had  
21 conducted its audits in compliance with professional standards of care. In performing its audit  
22 work for WaMu, Deloitte agreed and had a duty to perform such work in conformity with GAAP,  
23 as well as the standard of care established by the American Institute of Certified Public  
24 Accountant ("AICPA"), including the GAAS' Ten (10) Professional Standards of Care:

25 ***General Standards***

26 1. The audit must be performed by a person or persons having adequate technical training  
27 and proficiency as an auditor.

28 2. In all matters relating to the assignment, an independence in mental attitude is to be  
maintained by the auditor or auditors.

1 3. Due professional care is to be exercised in the planning and performance of the audit  
2 and the preparation of the report.

3 ***Standards of Field Work***

4 4. The work is to be adequately planned and assistants, if any, are to be properly  
5 supervised.

6 5. A sufficient understanding of internal controls is to be obtained to plan the audit and to  
7 determine the nature, timing, and extent of tests to be performed.

8 6. Sufficient competent evidential matter is to be obtained through inspection,  
9 observation, inquiries, and confirmations to afford a reasonable basis for an opinion  
10 regarding the financial statements under audit.

11 ***Standards of Reporting***

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

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

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

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

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

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



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

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

10 167. The misstatements of WaMu's quarterly and annual financial statements were  
11 material and in violation of GAAP. Deloitte breached its professional responsibilities and acted  
12 in violation of GAAP and GAAS in its review of the above-specified quarterly financials and  
13 audits of the annual financial statements of WaMu.

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

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

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

25 171. Deloitte violated AU section 316, which requires the auditor to plan and perform  
26 its examination of the financial statements with professional skepticism. Section 316 begins with  
27 the statement that: "the auditor has a responsibility to plan and perform the audit to obtain  
28

1 reasonable assurance about whether the financial statements are free of material misstatement,  
2 whether caused by error or fraud.” AU §316.01. In WaMu’s case, there were numerous audit red  
3 flags and risk factors that alerted Deloitte to the potential of misstatements.

4 172. Deloitte failed to expand its audit procedures and perform effective audit testing  
5 to obtain more reliable, persuasive audit evidence because of the above-described significant risk  
6 factors and audit red flags. As section 316 states, “[t]he nature of audit procedures may need to  
7 be changed to obtain evidence that is more reliable or to obtain additional corroborative  
8 information. For example, more evidential matter may be needed from independent sources  
9 outside the entity.” Deloitte failed to obtain adequate confirmations and/or otherwise  
10 communicate directly with affiliates of WaMu regarding the true value and exposure from  
11 WaMu’s loan practices and failed to fully understand the relationships between the parties,  
12 despite knowledge of risk factors and audit red flags that required action on Deloitte’s part.  
13 Section 316.27, which discusses the need to exercise professional skepticism in response to the  
14 risk of material misstatement, directs: (a) increased sensitivity in the selection of the nature and  
15 extent of documentation to be examined in support of material transactions, and (b) increased  
16 recognition of the need to corroborate management explanations or representations concerning  
17 materials matters.

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

22 174. Deloitte violated AU section 722.18, which states: “If, in performing a review of  
23 interim financial information, the accountant becomes aware of information that leads him or her  
24 to question whether the interim financial information to be reported conforms with generally  
25 accepted accounting principles, the accountant should make additional inquiries or employ other  
26 procedures he or she considers appropriate to provide the limited assurance for a review  
27 engagement.” In view of all the previously described risk factors and audit red flags at WaMu,  
28

1 Deloitte should have made additional inquiries, including further communications with  
2 customers and other related parties, as described above.

3 175. By giving of the unqualified audit opinions for the WaMu financial statements  
4 for fiscal years 2005, 2006 and 2007, Deloitte certified that its audits of WaMu's books and  
5 records were done in accordance with GAAP and GAAS. They were not. Thus, Deloitte's  
6 statements were materially misleading.

7 **V. CAUSES OF ACTION**

8 **FIRST CAUSE OF ACTION**

9 **(Fraud and Deceit)**

10 176. Plaintiff incorporates and realleges each of the foregoing paragraphs, as though  
11 fully set forth herein and further alleges as follows.

12 177. Defendants, and each of them, made material representations and omissions to  
13 Plaintiff which were false and misleading, including those contained in press releases, public  
14 statements, financial statements, SEC filings, registration statements, and other disclosures made  
15 by Defendants, described above.

16 178. As described above, Defendants understated the Company's Allowance by  
17 millions of dollars in each quarter, which had a dollar-for-dollar impact on the Company's  
18 reported pre-tax income. The effect on net income would be reduced by the Company's effective  
19 tax rate. As a result of Defendants' manipulation of the Company's Allowance, WaMu reported  
20 artificially inflated net income. WaMu should have increased its reserves during the to take into  
21 account the lower credit quality of its home loan portfolio. Defendants also concealed the  
22 inadequacy of WaMu's internal controls by falsely representing to investors that the Company's  
23 internal controls over financial reporting were effective. Defendants Killinger and Casey each  
24 repeatedly and falsely certified the design, operation and effectiveness of WaMu's internal  
25 controls in the Company's annual and quarterly financial statements. However, the Company's  
26 purported control environment failed to ensure that the financial statements issued were reliable  
27 or in compliance with applicable laws. Rather, Defendants focused on increasing loan volume  
28 origination without regard to the quality of such loans in an effort to reach aggressive market

1 share goals without taking the steps required under GAAP and SEC guidelines to account  
2 properly for their activities. In addition, Deloitte issued unqualified audit reports on WaMu's  
3 financial statements, which they knew and intended would be read and relied upon by  
4 prospective and existing investors in WaMu notes and securities, like the City, and which were in  
5 fact read and relied upon by the City in making its investment decisions.

6 179. When Defendants, and each of them, made the representations and failed to  
7 disclose and suppressed information they had a duty to disclose, as set forth hereinbefore,  
8 Defendants had knowledge of the falsity of their statements and representations and knew that  
9 they were failing to disclose material facts which they had a duty to disclose.

10 180. Defendants made the misrepresentations and omitted the material facts with the  
11 intent to defraud Plaintiff and to induce Plaintiff to purchase and hold the WaMu note.

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

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

19 183. Defendants knew that a fraud was occurring in the representations about WaMu.  
20 Notwithstanding their knowledge of this improper and unlawful conduct, these Defendants, and  
21 each of them, engaged in conduct, hereinbefore described which rendered substantial assistance  
22 to, encouraged and/or aided and abetted the fraud.

23 184. With knowledge of the unlawful purpose of the fraud, Defendants, and each of  
24 them, entered into an agreement to accomplish the aforesaid scheme, and by their actions took  
25 steps to further that scheme.

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

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

4 **SECOND CAUSE OF ACTION**

5 **(Negligent Misrepresentation)**

6 187. Plaintiff incorporates and realleges each of the foregoing paragraphs, as though  
7 fully set forth herein and further alleges as follows.

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

12 189. As described above, Defendants understated the Company's Allowance by  
13 millions of dollars in each quarter, which had a dollar-for-dollar impact on the Company's  
14 reported pre-tax income. The effect on net income would be reduced by the Company's effective  
15 tax rate. As a result of Defendants' manipulation of the Company's Allowance, WaMu reported  
16 artificially inflated net income. WaMu should have increased its reserves during the to take into  
17 account the lower credit quality of its home loan portfolio. Defendants also misrepresented the  
18 adequacy of WaMu's internal controls by falsely representing to investors that the Company's  
19 internal controls over financial reporting were effective. Defendants Killinger and Casey each  
20 repeatedly and falsely certified the design, operation and effectiveness of WaMu's internal  
21 controls in the Company's annual and quarterly financial statements. However, the Company's  
22 purported control environment failed to ensure that the financial statements issued were reliable  
23 or in compliance with applicable laws. Rather, Defendants focused on increasing loan volume  
24 origination without regard to the quality of such loans in an effort to reach aggressive market  
25 share goals without taking the steps required under GAAP and SEC guidelines to account  
26 properly for their activities. In addition, Deloitte issued unqualified audit reports on WaMu's  
27 financial statements, which it knew and intended would be read and relied upon by prospective  
28

1 and existing investors in WaMu notes and securities, like the City, and which were in fact read  
2 and relied upon by the City in making its investment decisions.

3 190. When Defendants, and each of them, made the representations, as set forth  
4 hereinbefore, Defendants had no reasonable ground for believing them to be true. Defendants  
5 made positive assertions in a manner not warranted by the information in their possession.  
6 Defendants made these assertions to induce the reliance of Plaintiff and to induce Plaintiff to  
7 purchase and hold the WaMu note.

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

12 192. Plaintiff reasonably relied on these representations, including Deloitte's  
13 unqualified audit reports, in investing in and continuing to hold the WaMu note and its reliance  
14 was justified.

15 193. Defendants, and each of them, engaged in conduct, hereinbefore described which  
16 rendered substantial assistance to, encouraged and/or aided and abetted the others' conduct.

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

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

1 **THIRD CAUSE OF ACTION**

2 **(Breach of Fiduciary Duty)**

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

5 197. By virtue of Plaintiff's ownership of the note that is the subject of this  
6 Complaint, the Individual Defendants, and each of them, as officers and directors of WaMu,  
7 owed fiduciary duties of the highest good faith, integrity and fair dealing to Plaintiff as a holder  
8 of the note. The Individual Defendants, and each of them, further owed fiduciary obligations to  
9 Plaintiff as they sought to induce, and did induce Plaintiff to purchase and hold the note,  
10 knowing of the City's particular circumstances.

11 198. The Individual Defendants and each of them, had insider knowledge of adverse  
12 non-public information regarding the securities as alleged above. The Individual Defendants  
13 knowingly and intentionally concealed this adverse non-public information from the Plaintiff.

14 199. The Individual Defendants, and each of them, breached and violated their  
15 fiduciary obligations to Plaintiff, to the detriment of Plaintiff, by failing to disclose all material  
16 information known to them at the time that Plaintiff purchased and held the note, and by making  
17 the above-mentioned misrepresentations to induce Plaintiff to purchase and hold the note or to  
18 take other actions.

19 200. As set forth above, the Defendants knew that WaMu was engaged in fraudulent  
20 conduct, and that the Individual Defendants, and each of them, were breaching their fiduciary  
21 duties to WaMu's note holders and investors. Notwithstanding their knowledge of the improper  
22 and unlawful conduct, the Defendants, and each of them, engaged in conduct, hereinbefore  
23 described which rendered substantial assistance to, encouraged and/or aided and abetted the  
24 breach of fiduciary duty.

25 201. With knowledge of the unlawful purpose of the conduct of WaMu, and the other  
26 Defendants, the Defendants, and each of them, entered into an agreement to accomplish the  
27 aforesaid scheme, and by their actions took steps to further that scheme.





1           208. As a direct and proximate result of the wrongful conduct of Defendants and each  
2 of them, Plaintiff has sustained economic losses and other general and special damages,  
3 including damages pursuant to Section 25500, in an amount to be determined according to proof  
4 at the time of trial.

5           209. Plaintiff is entitled to an award of prejudgment interest at the legal rate on its  
6 economic damages, pursuant to Section 25500.

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

8       **VI. PRAYER FOR RELIEF**

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

17       **VII. DEMAND FOR JURY TRIAL**

18           Plaintiff demands a trial by jury.

19       Dated: April 17, 2009

**COTCHETT, PITRE & McCARTHY**

20  
21       By:  (650)

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