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UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA



IN RE NEW CENTURY

) Case No. CV 07-00931 DDP (JTLx)
)
) **ORDER DENYING DEFENDANTS' MOTIONS**
) **TO DISMISS AND DENYING MOTION TO**
) **STRIKE**
)
) [Motions to Dismiss and Motion to
) Strike filed on June 2, 2008]
)
)

This is a securities class action that arises in the wake of the sub-prime mortgage lending crisis and the collapse of one of the industry's formerly largest sub-prime mortgage lenders, New Century Financial Corporation ("New Century"). Lead Plaintiff New York State Teachers Retirement System ("NYSTRS") brings this action on behalf of all persons and entities, other than Defendants, who purchased or acquired New Century common stock, New Century Series A Cumulative Redeemable Preferred Stock ("Series A Stock"), New Century Series B Cumulative Redeemable Preferred Stock ("Series B Stock"), and/or New Century call options, or who sold New Century put options, between May 5, 2005 and March 13, 2007 (the "Class

1 Period"). (Compl. ¶ 1.) Defendants are New Century officers
2 ("Officer Defendants"), its directors ("Director Defendants"), its
3 auditor KPMG ("KPMG"), and the underwriters of the stock offering
4 ("Underwriter Defendants").

5 Sub-prime lending involves originating and purchasing loans
6 for borrowers considered high-risk by traditional credit and
7 underwriting standards. (Compl. ¶ 2.) The recent sub-prime
8 mortgage lending crisis has caused many mortgage lending companies
9 - and the value of their stocks - to collapse. New Century became
10 one of the nation's largest mortgage finance companies by focusing
11 on sub-prime lending. (Compl. ¶ 2.) In 1996, when New Century was
12 formed, it had \$357 million in total loan originations and
13 purchases. For the year-ended December 31, 2005, New Century
14 reported \$56.1 billion in total loan originations and purchases.
15 (Compl. ¶¶ 55-60.) Sub-prime loans accounted for \$32.8 billion, or
16 62.2% of total loans financed or sold. (Compl. ¶ 65.)

17 In June 2005 and August 2006, New Century made offerings of
18 the Series A stock and Series B stock respectively. On February 7,
19 2007, a day before 2006 fourth-quarter and year-end results were
20 scheduled to be released, New Century issued a press release that
21 disclosed a restatement of earnings for the previous three quarters
22 of 2006. New Century stated that material weaknesses in internal
23 controls over financial reporting caused the reporting errors.
24 (Compl. ¶ 457.) Upon this announcement, New Century stock
25 plummeted by 36% the following day. (Id. at ¶ 459) In the period
26 subsequent to these and additional disclosures, (Id. at ¶¶ 464,
27 468-476), New Century stock further declined. On March 14, 2007,
28 New Century stock closed at \$ 0.67 per share, a 97% decline from

1 the over \$30 per share prior to the disclosures. (Id. at ¶ 9) The
2 Series A and Series B stock likewise fell by 75% during this
3 period. (Id. at ¶¶ 9, 478.)

4 Plaintiffs filed this lawsuit alleging securities violations
5 in connection with New Century's Series A and Series B stock.
6 Plaintiffs maintain that these declines were foreseeable, and that
7 Defendants made numerous material misstatements regarding New
8 Century's financial situation and business operations. In summary,
9 Plaintiffs allege that Defendants, during the Class Period,
10 misrepresented New Century's ability to repurchase defaulted loans;
11 overvalued its residual interests in securitizations; falsely
12 certified the adequacy of its internal controls, loan origination
13 standards, and the quality of its loans; and failed to identify
14 these problems in public statements, registration documents,
15 audits, or elsewhere. They claim that Defendants' material
16 misrepresentations and omissions violated Section 11 of the
17 Securities Act of 1933, 15 U.S.C. § 77k. They further claim that
18 the New Century Officer Defendants and KPMG violated sections 10(b)
19 and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §
20 78u-4(b), and Rule 10b-5 of the regulations promulgated by the
21 Securities and Exchange Commission ("SEC").

22 On April 30, 2008, Plaintiffs filed their second amended
23 consolidated class action complaint.¹ There are currently five

24
25 ¹ Lead Plaintiff New York State Teachers' Retirement System
26 originally filed its consolidated class action complaint on
27 September 14, 2007. Defendants filed several motions to dismiss
28 all or some of the claims alleged in Plaintiffs' complaint, and the
Court granted the motions with leave for Plaintiffs to file an
amended consolidated class action complaint. (Order Granting
Motions to Dismiss With Leave to Amend, January 31, 2008.) The
(continued...)

1 motions to dismiss and one motion to strike before the Court. The
2 Officer Defendants move to dismiss the securities fraud claims
3 under section 10(b) and Rule 10b-5, as well as the derivative
4 control person liability claims. Officer Defendant Robert Cole
5 files his own motion to dismiss the same claims. The Director
6 Defendants and Underwriter Defendants move to dismiss claims
7 alleging violations of section 11 of the Securities Act of 1933, 15
8 U.S.C. 77k, in connection with the Series A and Series B stock.
9 Those motions are joined by the Officer Defendants against whom
10 Plaintiffs also allege violations of section 11 of the Securities
11 Act. Defendant KPMG moves to dismiss the claim against it alleging
12 violations of section 11 of the Securities Act in connection with
13 Series B stock, and the securities fraud claim against it under
14 section 10(b) and Rule 10b-5. Defendant KPMG also moves to strike
15 all references in the Complaint to the Bankruptcy Report.

16 After reviewing the extensive briefing, hearing oral argument,
17 and considering the arguments raised by all parties, the Court
18 denies Defendants' motions to dismiss and denies Defendant KPMG's
19 motion to strike.

20 **I. BACKGROUND**

21 The Court's review on a motion to dismiss is generally limited
22 to the allegations in the Complaint, taken as true and construed in
23 the light most favorable to the non-moving party. Resnick v.

24

25

26 ¹(...continued)

27 Court's dismissal focused entirely on the organization of the
28 complaint, and its difficulty in evaluating the basis for
Plaintiffs' claims of securities law violations. The Court again
addresses the organization of the complaint below.

1 Hayes, 213 F.3d 443, 447 (9th Cir. 2000). The following background
2 is derived from Plaintiffs' second amended complaint ("Complaint").

3 A. The Parties

4 1. Plaintiffs

5 Lead Plaintiff New York State Teachers Retirement System
6 ("NYSTRS") has over 400,000 active members, retirees, and
7 beneficiaries.² NYSTRS provides retirement, disability, and death
8 benefits to eligible public school teachers in New York State.
9 NYSTRS purchased New Century common stock during the Class Period
10 and claims to have suffered damages due to the alleged wrongful
11 conduct. (Compl. ¶ 19.) Plaintiff Carl Larson acquired New
12 Century Series A and B Preferred Stock during the Class Period and
13 claims to have suffered damages due to the alleged wrongful
14 conduct. (Id. at ¶ 20.) Plaintiff Charles Hooten sold New Century
15 put options during the Class Period and claims to have suffered
16 damages due to the alleged wrongful conduct. (Id. at ¶¶ 21.)

17 2. Defendants

18 On April 2, 2007, New Century filed for Chapter 11 bankruptcy
19 protection. For this reason, the action against New Century has
20 been stayed. (Compl. ¶ 22.) Plaintiffs assert claims against
21 several other Defendants in this action. To be consistent, the
22 Court follows the categorization from the Complaint: New Century
23 Officer Defendants, New Century Director Defendants, KPMG, and New
24 Century Underwriters.

25
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27 _____
28 ²On June 26, 2007, the Court appointed NYSTRS as Lead
Plaintiff in this case.

1 The Officer Defendants were corporate officers of New Century
2 during the Class Period.³ (Compl. ¶¶ 23-26.) The officers' duties
3 included disseminating prompt, accurate information about the
4 Company's business, operations, financial statements and internal
5 controls, and correcting any previously issued statements that had
6 become materially untrue. They were involved in drafting,
7 producing, reviewing, and/or disseminating the alleged material
8 misstatements at issue in this case. (Id. at ¶¶ 27-29.)

9 The Director Defendants served as directors of New Century
10 during the Class Period.⁴ (Compl. ¶¶ 30-38.) Each of the Director
11 Defendants either signed the registration statements for Series A
12 and Series B stock, or were directors when the stock was offered to
13 the public. (Id.)

14 Defendant KPMG served as New Century's outside auditor during
15 the Class Period. (Compl. ¶ 39.) The Underwriter Defendants are
16 the investment banks that acted as underwriters to the public
17 offerings of New Century stock in June 2005.⁵ (Id. at ¶¶ 40-47.)

21 ³Robert K. Cole was Chairman of the Board of Directors
22 ("Board"), Chief Executive Officer, and a Director of the Company.
23 Brad A. Morrice was Vice Chairman of the Board and Company
24 President. Edward F. Gothschall was Vice Chairman of Finance and a
25 Director of the Company. Pattie M. Dodge was Executive Vice
26 President, Chief Financial Officer and Investor Relations.

27 ⁴The Directors were Federic J. Forster, Michael M. Sachs,
28 Harold A. Black, Donald E. Lange, Terrence P. Sandvik, Richard A.
Zona, Marilyn A. Alexander, William J. Popejoy, and David Einhorn.

⁵The Underwriter Defendants, all investment banks that acted
as underwriters for various public offerings, are Bear, Stearns &
Co. Inc; Piper Jaffray & Co.; Stifel, Nicolaus & Compan,
Incorporated; JMP Securities LLC; Roth Capital Partners, LLC;
Morgan Stanley & Co., Inc.; and Jefferies & Co., Inc.

1 B. New Century's Mortgage Lending, Whole Loan Sales, and
2 Securitizations

3 New Century primarily originated sub-prime mortgage loans.
4 Sub-prime lending refers to providing loans with typically high
5 interest rates to high-risk borrowers, who may have poor credit
6 histories, the lack of income documentation, or debt. The sub-
7 prime mortgage lending industry collapsed, in part, because high-
8 risk adjustable-rate interest-only loans, and "stated income" loans
9 resulted in increased default rates among borrowers. (Compl. ¶ 4.)

10 New Century's business was not limited to originating loans.
11 New Century, like many sub-prime lenders, sought to sell its loans
12 in a secondary market and recognize a "gain on sale" of those
13 loans. New Century either made (1) whole loan sales; (2)
14 securitizations structured as sales; or (3) securitizations
15 structured as "financings." (Compl. ¶ 61.) In whole loan sales,
16 New Century realized gains upon sale of a pool of loans to third-
17 parties. In securitizations structured as sales, New Century
18 realized gains by selling a pool of loans to a trust, and receiving
19 cash flows from its residual interests in the securitized pool of
20 loans. In securitizations structured as financings, New Century
21 did not record a gain on sale when it sold a pool of loans, but
22 rather, received interest income as payments on the mortgages were
23 made. (Compl. ¶¶ 61-64.)

24 C. New Century's Series A and Series B Preferred Stock
25 Offerings

26 In June 2005, New Century sold its Series A preferred stock,
27 for net proceeds of approximately \$109 million. The Underwriter
28 Defendants, excluding Morgan Stanley and Jefferies & Co., provided

1 underwriting for the offering. The Series A stock was sold
2 pursuant to a Form S-3 registration statement and prospectus.
3 These documents are collectively referred to as "Series A
4 Registration Statement."⁶ (Compl. ¶¶ 236-238.) The Series A
5 Registration Statement incorporated by reference the following
6 documents: New Century's quarterly report (Form 10-Q) for the
7 quarter ended March 31, 2005 and current report (Form 8-K) filed on
8 or around May 5, 2005. (Id. at ¶ 238.) The Form 8-K had a May 5,
9 2005 press release attached as an exhibit.

10 In August 2006, New Century sold its Series B preferred stock,
11 for net proceeds of approximately \$55.6 million. The Underwriter
12 Defendants, excluding Deutsche Bank, Piper Jaffray, JMP Securities,
13 and Roth Capital, provided underwriting for the offering. The
14 Series B stock was also sold pursuant to a Form S-3 registration
15 statement and general prospectus. These documents are collectively
16 referred to as "Series B Registration Statement."⁷ (Compl. ¶¶ 256-
17 258.) The Series B Registration Statement incorporated by
18 reference the following documents: New Century's annual report
19 (Form 10-K) for the year-ended December 31, 2005, quarterly reports
20 (Forms 10-Q) for the quarters ending March 31, 2006 and June 30,
21 2006. (Id. at ¶ 258.)

22 D. New Century's Disclosures

23 On February, 7, 2007, New Century disclosed that during
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26 ⁶In the Complaint, the documents are referred to as "Series A
27 Preferred Stock Registration Statement." (177)

28 ⁷In the Complaint, the documents are referred to as "Series B
Preferred Stock Registration Statement." (185)

1 the first three quarters of 2006, it did not properly discount the
2 allowance for loan repurchase losses "by the amount the repurchase
3 prices exceed the fair values" and "did not properly consider . . .
4 the growing volume of repurchase claims that resulted from the
5 increased pace of repurchase requests that occurred in 2006 . . .
6 ." (Compl. ¶ 457.) It explained that "earnings-related press
7 releases for those periods should no longer be relied upon" and to
8 expect "a net loss for that period." (Id.) It further noted that
9 "errors leading to these restatements constitute material
10 weaknesses in its internal control over financial reporting for the
11 year ended December 31, 2006." New Century additionally explained
12 that adjustments were expected for its residual interests held as
13 securities. (Id.)

14 On March 1, 2007, New Century disclosed that it would be
15 unable to file a timely 2006 year-end financial report (Form 10-K).
16 On March 2, 2007, New Century filed a notification of late filing
17 with the SEC, in which it stated that its Audit Committee had
18 initiated an independent investigation of the issues related to the
19 need for financial restatements; that it expected to conclude that
20 there were material weaknesses in internal control over financial
21 reporting; that modifications to the ALL would result in lower,
22 restated net income for the first three quarters of 2006; that
23 there were declines in earnings and profitability for 2006; and
24 provided additional disclosures, including that the SEC requested a
25 meeting with the company and the U.S. Attorney's Office had
26 initiated a criminal investigation. (Compl. ¶ 464.)

27 On March 12, 2007, New Century disclosed that certain lenders
28 discontinued financing for the company, that this would allow

1 lenders to accelerate the company's obligations to repurchase
2 loans, and that this could total \$8.4 billion in repayment
3 obligations. New Century further disclosed that it lacked the
4 liquidity to keep pace with the repurchase requests. (Id. at ¶
5 472.) After close of trading on March 13, 2007, the New York Stock
6 Exchange delisted New Century stock. (Id. at ¶ 476.)

7 On May 24, 2007, New Century filed a Form 8-K providing that,
8 in addition to its restatements with respect to 2006, the Audit
9 Committee had found "errors in the Company's previously filed
10 annual financial statements [for 2005] . . . with respect to both
11 the accounting and reporting of loan repurchase losses," and found
12 it "more likely than not that these errors . . . resulted in a
13 material overstatement of pretax earnings . . . [such that] the
14 [annual financial statements for 2005] should no longer be relied
15 upon." (Compl. ¶ 482.) The Form 8-K further explained that New
16 Century had overstated its residual interests. (Id. at ¶ 96)

17 On April 2, 2007, New Century filed for Chapter 11 bankruptcy
18 protection. (Id. at ¶ 480.) On February 29, 2008 the Bankruptcy
19 Examiner's Report was filed, and was publicly released on March 26,
20 2008.

21 E. Plaintiffs' Allegations of Material Misstatements and
22 Scienter

23 The Complaint alleges that Defendants were responsible for
24 false and misleading statements regarding New Century's financial
25 condition, internal controls, underwriting standards and loan
26 quality, and in audits of the company, and improper underwriting
27 and auditing standards. The Complaint further alleges that the
28 Officer Defendants and KPMG's alleged misrepresentations were

1 fraudulently made. The Complaint asserts that these misstatements
2 caused damages to New Century shareholders.

3 1. New Century's Financial Statements and GAAP
4 Compliance

5 Plaintiffs' Complaint alleges that New Century's financial
6 statements in 2005 and 2006, during the Class Period, contained a
7 number of false and misleading statements in violation of generally
8 accepted accounting principles ("GAAP"). (Compl. ¶ 66.)

9 First, the Complaint alleges that New Century materially
10 understated its reserve fund for repurchase of loans in default.
11 (Id. at ¶¶ 69-100.) The GAAP required New Century to maintain an
12 allowance for repurchase losses ("reserve"), which provides a
13 reserve to repurchase loans purchased by third-parties in the event
14 of payment defaults by borrowers. (Id. at ¶¶ 70, 457.) Upon
15 repurchase of the loans, New Century was required to list those
16 loans on its balance sheet as "Mortgage Loans Held for Sale", and
17 to reduce the repurchase reserve by the amount that the repurchase
18 prices exceeded fair value. (Id. at ¶ 70.)

19 In its 2005 Form 10-K, New Century represented that the
20 reserve was "adequate" based on a risk evaluation. (Id. at ¶ 71.)
21 In its disclosures on February 7, 2007, New Century provided that
22 its financial statements for the first three quarters of 2006 were
23 inaccurate because the reserve was understated, due to improper
24 accounting and weak internal controls over financial reporting.
25 (Id. at ¶ 72.) In disclosures on May 24, 2007, New Century further
26 provided that the 2005 financial statements needed restatement due
27 to "errors" in "both the accounting and reporting of loan
28 repurchase losses." (Id. at ¶ 73.) Based on these disclosures,

1 information provided by several former employees, and additional
2 documents, the Complaint alleges that the reserve was inadequate to
3 keep up with mounting repurchase claims, the reserve was materially
4 understated by tens of millions of dollars during the Class Period,
5 and in effect, this overstated New Century's income. (Id. at ¶ 74,
6 91, 95, 100.)

7 Second, the Complaint alleges that New Century materially
8 misstated the value of residual interests in securitizations
9 structured as sales. (Id. at ¶ 101.) New Century reflected the
10 present value of residual interests in a securitized pool of loans
11 on its balance sheet. Its quarterly valuation involved an
12 estimation of the effect of delinquencies and defaults on the
13 expected cash flows from these residual interests. (Id. at ¶¶ 102-
14 103.) The February 7, 2007 and May 24, 2007 disclosures referred
15 to "errors" in the valuation of residual interests. (Id. at ¶¶
16 105.) The Complaint alleges that the value of New Century's
17 residual interests were inflated as a result of a failure to
18 account for decreasing loan quality and underwriting standards, and
19 for increased rates of delinquencies and defaults during 2005 and
20 2006. (Id. at ¶¶ 104-105.)

21 Third, the Complaint alleges that New Century misrepresented
22 its Allowance for Loan Losses ("ALL"), which was a reserve of funds
23 to cover losses on "Mortgage Loans Held for Investment." (Compl. ¶
24 109-118.) New Century evaluated the ALL based upon "the
25 performance of loans, credit characteristics of the portfolio, the
26 value of the underlying collateral and the general economic
27 environment. (Id. at ¶ 110.) Yet the ALL was actually decreasing
28 as a percentage of "Mortgage Loans Held for Investment" that were

1 60 or more days delinquent, and was being reduced as the rate of
2 delinquent loans was rising. (Id. at ¶¶ 111-112.) The Complaint
3 alleges that New Century's ALL failed to meet GAAP and SEC
4 requirements during the Class Period. (Id. at ¶ 115.)

5 Finally, the Complaint alleges a number of additional GAAP
6 violations related to mortgage servicing rights, deferred
7 origination fees, hedging, and goodwill. These alleged violations
8 are based upon the Bankruptcy Examiner's report. (Id. at ¶ 119.)

9 2. New Century's Underwriting and Loan Quality

10 The Complaint alleges that Defendants made false and
11 misleading statements regarding New Century's underwriting
12 standards and loan quality. During the Class Period, the Officer
13 Defendants made public statements regarding the company's "strong,"
14 "excellent," "very high" credit quality, and that the credit
15 quality was "better" than in the past because the Company used
16 "strict," "improved," and "strong" underwriting guidelines.
17 (Compl. ¶ 120.) These public statements were contrary to data on
18 increasing defaults. (Id. at ¶¶ 120-121.) Also contrary to these
19 statements, and notwithstanding the increasing interest rates and
20 downturn in the real estate market, the underwriting standards were
21 loosened in order to increase the volume of loans. (Id. at ¶ 125.)
22 The Complaint recites data and confidential witness statements that
23 purport to show the rising rates of delinquent New Century loans,
24 the poor quality of loans issued by New Century, weak internal
25 controls, and lenient loan origination standards. (Id. at ¶¶ 126-
26 168.) The convergence of these factors created a "recipe for
27 disaster[.]" (Id. at ¶ 172.)

28

1 The Complaint alleges that New Century Officer Defendants
2 touted the company's internal controls, loan quality, and
3 underwriting standards throughout the Class Period. (Compl. ¶ 191.)
4 The Complaint points to specific statements by individual officers.
5 These statements are alleged to have been false and misleading
6 given evidence of inadequate lending practices including
7 significant deficiencies and material weaknesses in internal
8 controls, some which the company admitted and others which were
9 undisclosed. (Id. at ¶¶ 193-194.) The Complaint maintains that
10 these were material misrepresentations, and cannot be explained
11 away by market forces. (Id. at ¶¶ 125-130.)

12 The Complaint further alleges, with respect to the Officer
13 Defendants, that each made knowing and reckless misstatements. Each
14 signed quarterly certifications that the company's internal
15 controls were adequate. These certifications were made in spite of
16 overwhelming evidence that internal controls and loan quality were
17 inadequate. (Id. at ¶¶ 486-487.) Each also signed the SEC filings
18 attesting that its accounting practices complied with GAAP in
19 relation to the loan repurchase reserve and the reporting of
20 residual interests. Similarly, the Complaint alleges violations of
21 the GAAP in maintenance of the reserve and valuation of residual
22 interests. (Id. at ¶¶ 23-26, 489.) Several statements, such as
23 describing the repurchase requests as "modest", are alleged to be
24 knowing and reckless misstatements in light of the known rise in
25 defaults and inadequacy of the reserve. (Id. at ¶¶ 438, 452.)
26 Moreover, Defendant Dodge is alleged to have failed to disclose to
27 the Audit Committee a change in the methodology for calculating the
28 repurchase reserve, although she had the opportunity to do so.

1 (Id. at ¶ 497.) The Officer Defendants received over \$50 million
2 in dividend payments as New Century's loan origination increased.
3 The Complaint further alleges a motivation to enlarge loan volume
4 and reduce repurchase reserves to inflate earnings no matter the
5 risk to the company and its investors. (Id. at ¶¶ 502-514.)

6 3. KPMG's Audit Opinions

7 The Complaint alleges that KPMG issued audit opinions
8 regarding (i) New Century's 2005 year-end financial statements and
9 (ii) New Century's internal controls as of December 31, 2005, that
10 contained material misstatements in violation of the Public Company
11 Accounting Oversight Board ("PCAOB") standards. (Compl. ¶ 206.)
12 Both of these opinions were incorporated into the Series B stock
13 offering. (Id. at ¶ 207.)

14 The PCAOB has adopted the generally accepted auditing
15 standards ("GAAS"). (Id. at ¶ 205.) The GAAS require an auditor
16 to exercise due professional care, to adequately plan its audit, to
17 sufficiently understand a business's internal structure, and to
18 obtain sufficient evidence to reach reasonable conclusions. (Id.
19 at ¶ 210.) KPMG allegedly failed to adhere to the GAAS by having
20 an inexperienced audit team, (id. ¶ 222-223); failed to challenge
21 New Century management for its low discount rates on residual
22 interests or its hedge accounting (id. at ¶ 224-226); failed to
23 test the repurchase reserve despite evidence of internal control
24 weaknesses and apparently inaccurate estimates of outstanding
25 repurchase requests (id. at ¶¶ 227-229); failed to properly
26 identify the flaws in valuation of residual interests (id. at ¶¶
27 231-32); and failed to raise deficiencies and inaccuracies in New
28

1 Century's accounting practices or internal controls. (Id. at ¶¶
2 233-234.)

3 The Complaint further alleges that KPMG's misstatements were
4 deliberately or recklessly false and misleading. KPMG auditors
5 simply ignored evidence that New Century needed to improve its
6 accounting practices, including recommendations from other KPMG
7 experts. (Id. at ¶¶ 516-519.) KPMG made conscious decisions to
8 allow inexperienced staff, including first-year auditors in some
9 instances, to conduct analyses of accounting and internal controls.
10 (Id. at ¶¶ 520-522.) In 2004, KPMG identified New Century's
11 failure to adopt appropriate procedures for calculation of the
12 repurchase reserve, but when that problem was again identified in
13 2005, KPMG still determined that the problem was not a significant
14 deficiency. (Id. at ¶¶ 523-524.) KPMG identified weaknesses in
15 valuation of residual interests, but accepted New Century's
16 valuations in spite of evidence that indicated those valuations
17 were predicated on doubtful assumptions. (Id. at ¶¶ 525.) The
18 Complaint sets KPMG's failure to challenge New Century's business
19 practices in its audits against the findings of significant
20 deficiencies in 2006 and since. (Id. at ¶¶ 527-528.)

21 F. Plaintiff's Claims

22 This action alleges the following claims: (1) violations of
23 Section 11 of the Securities Act in connection with the Series A
24 stock against the Officer Defendants, the Director Defendants, and
25 the Underwriter Defendants Bear Stearns, Deutsche Bank, Piper
26 Jaffray, Stifel Nicolaus, JMP Securities, and Roth Capital; (2)
27 violations of Section 15 of the Securities Act in connection with
28 the Series A stock against the Officer Defendants for control

1 person liability based upon Section 11 and Section 12(a) violations
2 by New Century; (3) violations of Section 11 of the Securities Act
3 in connection with the Series B stock against the Officer
4 Defendants, the Director Defendants,⁸ and the Underwriter
5 Defendants Bear Stearns, Morgan Stanley, Stifel Nicolaus, and
6 Jeffries & Company; (4) violations of Section 15 of the Securities
7 Act in connection with the Series B stock against the Officer
8 Defendants for control person liability based upon Section 11 and
9 Section 12(a) violations by New Century; (5) violations of Section
10 10(b) of the Exchange Act against the Officer Defendants; (6)
11 violations of Section 20(a) of the Exchange Act against the Officer
12 Defendants; and (7) violations of Section 10(b) of the Exchange Act
13 against KPMG. (Compl. ¶¶ 289-340, 551-571.)

14 **II. DISCUSSION**

15 A. Legal Standard - Motions to Dismiss

16 Federal Rule of Civil Procedure 8(a) provides that a complaint
17 need only contain "(1) a short and plain statement of . . .
18 jurisdiction, . . . (2) a short and plain statement of the claim
19 showing that the pleader is entitled to relief, and (3) a demand
20 for judgment for the relief the pleader seeks." Federal Rule of
21 Civil Procedure 9(b) provides that the "circumstances constituting
22 fraud or mistake shall be stated with particularity" in a
23 complaint. Under Federal Rule of Civil Procedure 12(b)(6), a
24 complaint must be dismissed when a plaintiff's allegations fail to
25 state a claim upon which relief can be granted.

26

27 ⁸Count One with respect to Series A Stock is not raised
28 against director Einhorn. Count Three with respect to Series B
stock is not raised against directors Sandvik and Popejoy.

1 When considering a 12(b)(6) motion to dismiss for failure to
2 state a claim, "all allegations of material fact are accepted as
3 true and should be construed in the light most favorable to the
4 plaintiff." Resnick v. Hayes, 213 F.3d 443, 447 (9th Cir. 2000);
5 accord Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct.
6 2499, 2509 (2007). A court properly dismisses a complaint on a
7 Rule 12(b)(6) motion based upon the "lack of a cognizable legal
8 theory" or "the absence of sufficient facts alleged under the
9 cognizable legal theory." Balistreri v. Pacifica Police Dept., 901
10 F.2d 696, 699 (9th Cir. 1990).⁹

11 B. The Organization of the Second Amended Complaint

12 On January 31, 2008, the Court granted Defendants' motions to
13 dismiss with leave for Plaintiffs to amend their Complaint. The
14 Court's Order focused almost entirely on its difficulty evaluating
15 whether Plaintiffs stated a claim in light of the organization and
16 length of the Complaint. The Court granted leave to amend so that
17 Plaintiffs could reorganize and revise their allegations with an
18 eye toward clarity.

21 ⁹Recently, in Bell Atlantic Corp. v. Twombly, 127 S. Ct. 1955
22 (2007), the Supreme Court emphasized that "a plaintiff's obligation
23 to provide the grounds of his entitlement to relief requires more
24 than labels and conclusions, and a formulaic recitation of the
25 elements of a cause of action will not do." Id. at 1964-65
26 (internal quotation marks and alterations omitted). The Court made
27 clear, however, that its holding did "not require heightened fact
28 pleading of specifics, but only enough facts to state a claim to
relief that is plausible on its face." Id. at 1974. Twombly warns
of the insufficiency complaints filled with "legal conclusion[s]
couched as [] factual allegation[s]." Id. at 1965 (internal
quotation marks omitted). Yet it does not fundamentally alter Rule
8's pleading requirements, which is designed to "give the defendant
fair notice." Id. at 1964 (internal quotation marks omitted).

1 Defendants read this Court's prior Order to require dismissal
2 here. Having once before dismissed Plaintiffs' Complaint for lack
3 of organization, Defendants sense that they may again prevail on
4 this basis. Defendants go to great lengths to point out all of the
5 ways that Plaintiffs have failed to comply with the Court's prior
6 Order, have persisted in drafting disorganized, meandering
7 allegations, and have engaged in "puzzle-pleading."

8 The Court shares Defendants' frustration with the length of
9 the Second Amended Complaint. It is truly massive. As the Officer
10 Defendants pointed out at oral argument, the Consolidated Complaint
11 that was subject to the Court's January 31, 2008 Order ran roughly
12 100 pages. The Second Amended Complaint weighs in at nearly 375
13 pages of allegations, with nearly 200 additional pages of charts.
14 Although the Court recognizes that a complicated case necessarily
15 requires a complicated complaint, the Court finds it difficult to
16 fathom that the Complaint could not have been significantly more
17 concise. It appears to the Court that Plaintiffs' approach in the
18 Second Amended Complaint was to reproduce much of the Bankruptcy
19 Examiner's Report in the Complaint alongside Plaintiffs' other
20 allegations.¹⁰ The Court questions whether the Complaint provides
21 manageable roadmap for litigation.

22 Nevertheless, despite these remaining reservations, the Court
23 does not consider its prior Order to serve as a basis for dismissal
24 on the instant motions. The Court finds Plaintiffs' Second Amended
25 Complaint to be responsive to the concerns with clarity it

27 ¹⁰In addition to quoting the Report at length, the Complaint
28 also cites lengthy chunks of pages from it. (See, e.g., Compl.
¶ 174 (citing pages 109-76 of the Bankruptcy Examiner's Report).)

1 expressed in the January 31, 2008 Order. The Complaint has been
2 extensively revised. Plaintiffs have both eliminated certain
3 allegations and added additional information. Plaintiffs have
4 provided charts that provide additional structure to allegations of
5 false and misleading statements. And despite the lengthy quotation
6 from the Bankruptcy Examiner's Report, Plaintiffs' organization
7 shows that this quotation was deliberate and selective. The Court
8 is now able to evaluate whether the allegations sufficiently state
9 a claim. To the extent that the Complaint fails to identify false
10 and misleading statements, or lacks sufficient particularity when
11 required, the Court will rule accordingly. Any continuing lack of
12 simplicity and conciseness in the allegations will likely hurt
13 rather than help Plaintiffs' position.

14 This Court, like many others, will not hesitate to dismiss
15 long, unwieldy pleadings. See, e.g., In re Splash Technology
16 Holdings, Inc. Securities Litig., 160 F. Supp. 2d 1059, 1073 (N.D.
17 Cal. 2001). Neither courts nor defendants should have to wade
18 through the morass of "puzzle pleadings" as this wastes judicial
19 resources and undermines the requisite notice for a defendant to
20 respond. See id. at 1073-75. Yet a long and detailed complaint is
21 not a work of "puzzle pleading" as a matter of law. Furthermore,
22 in the securities class action context, the stringent pleading
23 requirements appear to invite both parties to throw everything and
24 the kitchen sink into their respective pleadings and motions to
25 dismiss. The plaintiff creates an inevitably detailed complaint in
26 anticipation of defendants' rigorous 12(b)(6) motions, and the
27 plaintiff's expectations are confirmed when defendants in due
28 course file those motions.

1 The plaintiff has the responsibility to craft a clear and
2 concise complaint, but the allegations that discharge this
3 responsibility will depend on the type of action, the specific
4 facts, the number of parties, and other variables. Here,
5 Plaintiffs' Complaint provides adequate organization and
6 sufficiently clear allegations such that this Court is able to rule
7 on Defendants' motions, and Defendants have adequate notice of the
8 allegations against them. Is the pleading still long? Yes. Is it
9 still extremely detailed and complex? Yes. Is this by itself a
10 reason to dismiss the complaint? No.

11 Nevertheless, the Court notes that the complexity of pleadings
12 and motions to dismiss in securities cases appears to be endemic.
13 In the future, the Court may consider alternative mechanisms, in
14 addition to the regular noticed motion process, to resolve issues
15 in this case in a manner that streamlines arguments, avoids
16 overlap, and conserves judicial resources. For now, the Court
17 proceeds to review Plaintiffs' Complaint and Defendants' motions.

18 C. Defendants' Requests for Judicial Notice

19 In deciding motions to dismiss, a court may "generally
20 consider only allegations contained in the pleadings, exhibits
21 attached to the complaint, and matters properly subject to judicial
22 notice." Swartz v. KPMG LLP, 476 F.3d 756, 763 (9th Cir. 2007). A
23 court may take judicial notice of facts that are "not subject to
24 reasonable dispute." Fed. R. Evid. 201(b). A court also may
25 consider documents that are referred to in the complaint, that are
26 "central" to the plaintiff's claims, and whose authenticity is
27 undisputed. See, e.g., Branch v. Tunnell, 14 F.3d 449, 454 (9th
28

1 Cir. 1994), overruled on other grounds, 307 F.3d 1119, 1127 (9th
2 Cir. 2002).

3 Here, Defendants have requested that the Court take judicial
4 notice of a number of documents, mostly SEC filings. (See Officer
5 Defendants' Request for Judicial Notice ("RJN"); Officer
6 Defendants' Suppl. RJN; Underwriter Defendants RJN; Defendant
7 Robert Cole's RJN; Defendant KPMG's RJN.) It is well-established
8 that courts may take judicial notice of SEC filings. See Dreiling
9 v. Am. Express Co., 458 F.3d 942, 946 n.2 (9th Cir. 2006). The
10 Court takes judicial notice of the SEC documents submitted by
11 Defendants. The Officer Defendants also request that the Court
12 take judicial notice of the Bankruptcy Examiner's Report. The
13 Court finds that it may consider the Report either as a document
14 referred to in Plaintiffs' Complaint or as a document subject to
15 judicial notice. The Underwriter Defendants request judicial
16 notice of excerpts from the Statement of Financial Accounting
17 Standards ("SFAS"). The Court also grants that request.

18 D. Defendant KPMG's Motion to Strike

19 Under Federal Rule of Civil Procedure 12(f), a court
20 "may order stricken from any pleading . . . any redundant,
21 immaterial, impertinent, or scandalous matter." Motions to strike
22 are not favored and "should not be granted unless it is clear that
23 the matter to be stricken could have no possible bearing on the
24 subject matter of the litigation." Colaprico v. Sun Microsystem,
25 Inc., 758 F. Supp. 1335, 1339 (N.D. Cal. 1991). This is "because
26 of the limited importance of pleadings in federal practice and
27 because [a motion to strike] is usually used as a delaying tactic."
28

1 RDF Media Ltd. B. Fox Broad. Co., 372 F. Supp. 2d 556, 561 (C.D.
2 Cal. 2005).

3 Courts will not grant motions to strike unless "convinced that
4 there are no questions of fact, that any questions of law are clear
5 and not in dispute, and that under no set of circumstances could
6 the claim or defense succeed." Id. When ruling on a motion to
7 strike, this Court "must view the pleading under attack in the
8 light most favorable to the pleader." Id. For a motion to strike
9 to be granted, the grounds for the motion must appear either on the
10 face of the complaint or from matters of which the Court may take
11 judicial notice. See SEC v. Sands, 902 F. Supp. 1149, 1165 (C.D.
12 Cal. 1995).

13 Here, Defendant KPMG moves to strike all references in the
14 Complaint to the Bankruptcy Examiner's Report. KPMG argues that
15 Plaintiffs' reliance on the Examiner's Report violates their duty
16 under Federal Rule of Civil Procedure 11 to conduct "a 'reasonable
17 and competent inquiry' into the facts of the case before signing
18 and filing the complaint." (KPMG's Mot. Strike 4 (citing Christian
19 v. Mattel, Inc., 286 F.3d 1118, 1127 (9th Cir. 2002))). KPMG
20 points to several cases where a plaintiff's adoption of allegations
21 drawn from non-party's complaint or report have been stricken, at
22 least until such time as the plaintiff has conducted an independent
23 investigation of those allegations. See, e.g., In re Connetics
24 Corp. Secs. Litig., 542 F. Supp. 2d 996, 1004-06 (N.D. Cal. 2008)
25 (striking allegations drawn from SEC complaint, but allowing
26 amendment if plaintiff conducted a reasonable investigation into
27 those allegations).

28

1 Plaintiffs counter that the relevant inquiry is not whether
2 attorneys personally verify allegations from such a report, but
3 rather, whether the source is reliable. See Daou, 411 F.3d at 1015
4 (finding that "sources relied upon in a complaint should be
5 'described in the complaint with sufficient particularity to
6 support the probability that a person in the position occupied by
7 the source would possess the information alleged"). Plaintiffs
8 maintain that the Examiner's Report is a reliable source. Contrary
9 to KPMG's cited authority, Plaintiffs point to case law where
10 allegations drawn from a bankruptcy examiner's report were allowed,
11 and were not stricken. See In re Enron Corp. Secs. Litig.,
12 MDL-1446, CV No. H-01-3624, 2005 U.S. Dist. LEXIS 41240, at *23
13 (N.D. Tex. Dec. 22, 2005).

14 The Ninth Circuit in Daou determined that a plaintiff must
15 state with particularity the sources of information alleged, and
16 that satisfaction of this requirement allows a court to accept
17 allegations issuing from those sources, as long as there are
18 "adequate corroborating details." Daou, 411 F.3d at 1015
19 (citations omitted). The court noted that it adopted this standard
20 from the Second Circuit's decision in Novak v. Kasaks, 216 F.3d
21 300, 314 (2d Cir. 2000). In the Enron litigation, the district
22 court also relied on Novak in allowing the plaintiff's allegations
23 drawn from the bankruptcy examiner's report. The court explained
24 that the PSLRA does not require a plaintiff to plead facts from
25 personal knowledge, id. at *23 n. 11, and indicated that a
26 plaintiff may meet the PSLRA pleading requirements "by providing
27 documentary evidence and/or sufficient general description of the
28 personal sources of the plaintiffs' beliefs," id. (quoting Novak,

1 216 F.3d at 314). The court found that the bankruptcy examiner's
2 report was documentary evidence, noted the examiner's statutory
3 obligation to perform a "disinterested" investigation, and thus
4 found that the plaintiff was permitted to rely on the report. Id.
5 at *23 n.11, *35-40.

6 Here, Plaintiffs have recited a significant number of
7 statements from the Examiner's Report. Plaintiffs do not indicate
8 that they have independently investigated the Examiner's statements
9 in the report. Instead, Plaintiffs emphasize the reliability of
10 the report as a source of information regarding New Century and
11 Defendants' practices, and that the report only supplements the
12 investigation made in preparation of the Complaint.¹¹ The Court
13 will allow the allegations drawn from the Examiner's Report because
14 the allegations are derived from documentary evidence that
15 qualifies as a reliable source for pleading purposes. See Daou,
16 411 F.3d at 1015; In re Enron Corp. Secs. Litig., 2005 U.S. Dist.
17 LEXIS 41240, at *23 n.11.

18 Plaintiffs are thus entitled to rely on the report in framing
19 allegations to satisfy the PSLRA's pleading requirements.¹²
20 Although Plaintiffs did not attach the Examiner's Report as an
21 exhibit to their Complaint, the Court may consider the report
22 because it is referred to in the complaint, is "central" to the
23 plaintiff's claims, and its authenticity is undisputed. See, e.g.,

24
25 ¹¹The Complaint makes clear that Plaintiffs have investigated
other allegations in the Complaint.

26 ¹²KPMG's objection that the report is hearsay is a non-issue
27 at the pleading stage. See In re McKesson HBOC, Inc. Sec. Litig.,
126 F. Supp. 2d 1248, 1272 (N.D. Cal. 2000) (noting that
28 plaintiffs, at the pleading stage, "are only required to plead
facts, not to produce admissible evidence").

1 Branch, 14 F.3d at 454. The Court has already taken judicial
2 notice of the report. Moreover, as was noted by the Enron court,
3 there is no requirement that consideration of the report be limited
4 to those excerpts quoted by Plaintiffs in their complaint; rather,
5 because the complaint refers to the report, "the Court can view any
6 statement selectively quoted or referenced in the context from
7 which it was drawn to protect against any misrepresentation or
8 misinterpretation." See In re Enron Corp. Secs. Litig., 2005 U.S.
9 Dist. LEXIS 41240, at *40 n.20.

10 KPMG additionally moves to strike Exhibits D and E to the
11 Complaint, which are the charts requested by the Court in its
12 January 31, 2008 Order. The Court declines to strike the charts.
13 To the extent that Plaintiffs may misrepresent KPMG's
14 responsibility for any statements, the Court will review the
15 Complaint and the attached exhibits, and make any appropriate
16 determinations.

17 E. Plaintiffs' Claims Under Sections 10(b) and 20(a) of the
18 Exchange Act Against the Officer Defendants

19 The Private Securities Litigation Reform Act, 15 U.S.C. §
20 78u-4, requires securities fraud claims to satisfy the heightened
21 pleading requirement "that a complaint plead with particularity
22 both falsity and scienter." In re Vantive Corp. Sec. Litig., 283
23 F.3d 1079, 1084 (9th Cir. 2002) (citing Ronconi v. Larkin, 253 F.3d
24 423, 429 (9th Cir. 2001)). The PSLRA provides that
25 the complaint shall specify each statement alleged to have
26 been misleading, the reason or reasons why the statement is
27 misleading, and, if an allegation . . . is made on information

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1 and belief, the complaint shall state with particularity all
2 facts on which that belief is formed."

3 15 U.S.C. § 78u-4(b)(1).

4 A plaintiff must also "state with particularity . . . facts
5 giving rise to a strong inference that the defendant acted with the
6 required state of mind." 15 U.S.C. § 78u-4(b)(2). The "required
7 state of mind" is "deliberate[] reckless[ness] or conscious
8 misconduct." In re Silicon Graphics Sec. Litig., 183 F.3d 970, 974
9 (9th Cir. 1999). The facts alleged in a complaint will give rise
10 to a "strong inference" of scienter when it "plead[s] facts
11 rendering an inference of scienter *at least as likely* as any
12 plausible opposing inference." Tellabs, Inc., et al. v. Makor
13 Issues & Rights, Inc., 127 S. Ct. 2499, 2513 (2007).

14 In evaluating whether the pleadings suggest a strong inference of
15 scienter, the Court must consider the allegations in the Complaint
16 "holistically." Id. at 2511.

17 1. Section 10(b) of the Exchange Act

18 Section 10(b) of the Securities Exchange Act provides, in
19 part, that it is unlawful "to use or employ in connection with the
20 purchase or sale of any security registered on a national
21 securities exchange or any security not so registered, any
22 manipulative or deceptive device or contrivance in contravention of
23 such rules and regulations as the [SEC] may prescribe." 15 U.S.C.
24 § 78j(b). Rule 10b-5 makes it unlawful for any person to use
25 interstate commerce:

- 26 (a) To employ any device, scheme, or artifice to defraud,
27 (b) To make any untrue statement of a material fact or to omit
28 to state a material fact necessary in order to make the

1 statements made, in the light of the circumstances under which
2 they were made, not misleading, or

3 (c) To engage in any act, practice, or course of business
4 which operates or would operate as a fraud or deceit upon any
5 person, in connection with the purchase or sale of any
6 security.

7 17 C.F.R. § 240.10b-5.

8 The elements of a claim under section 10(b) are (1) the
9 misrepresentation or omission of a material fact, (2) scienter, (3)
10 plaintiff's reliance on the misrepresentation, and (4) damages.

11 See Paracor Finance, Inc. v. General Electric Capital Corp., 96
12 F.3d 1151, 1157 (9th Cir. 1996) (en banc). A plaintiff's complaint
13 must satisfy the PSLRA's particularity requirements. See In re
14 Silicon Graphics, 183 F.3d at 983.

15 a. Materially False and Misleading Statements

16 Plaintiffs claim three primary categories of
17 misrepresentations that give rise to liability under Section 10(b)
18 and Rule 10b-5: (1) misrepresentations in New Century's reporting
19 of its earnings, repurchase reserve, and residual interest
20 valuations; (2) misrepresentations of New Century's internal
21 controls; and (3) misrepresentations of New Century's loan quality
22 and underwriting. These misrepresentations are alleged to have
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24
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1 been made in press releases,¹³ investor conference calls and
2 meetings,¹⁴ and SEC 10-Q and 10-K forms.¹⁵

3 i. Group Pleading

4 Plaintiffs argue that they may rely on the group pleading
5 doctrine for company-issued press releases. (Opp. at 33-34.)¹⁶ The
6 Officer Defendants contest the viability of the group pleading
7 doctrine.

8 A question not decided by the Supreme Court in Tellabs, and
9 that remains open within the Ninth Circuit, is whether group
10 pleading remains viable after the PSLRA. See Tellabs, 127 S. Ct.
11 at 2511 n.6. A judicially-created way of satisfying the
12 particularity requirement of Rule 9(b), the group pleading doctrine

13
14 ¹³1st quarter 2005 earnings press release Statements
[hereinafter St. or Sts.] 1,2), 2nd quarter 2005 earnings press
15 release (), 3rd quarter 2005 earnings press release (9), 4th
quarter 2005 earnings press release), 1st quarter 2006 earnings
16 press release (32-34), 2nd quarter 2006 earnings press release
(39), September 2006 press release (45), 3rd quarter earnings press
17 release (46) . (Compl. Exh. E.)

18 ¹⁴1st quarter 2005 earnings conference call (3,4), 2nd quarter
2005 earnings conference call (3,4), September 2005 investor
19 roundtable (15, 16), 3rd quarter 2005 earnings conference call (18-
20), 4th quarter and year-end earnings conference call (26-27), 4th
quarter earnings conference call (42), 3rd quarter 2006 investor
and analyst conference call (47-48) (Compl. Exh. E.)

21 ¹⁵1st quarter 2005 Form 10-Q (5), 2nd quarter 2005 Form 10-Q
22 (11-14), 3rd quarter 2005 Form 10-Q (21), year-end 2005 10-K Form
(28-31), 1st quarter 2006 Form 10-Q (35-38), 2nd quarter 2006 Form
23 10-Q (41-44), 3rd quarter 2006 Form 10-Q (49-52). (Compl. Exh. E.)

24 ¹⁶Where the Officer Defendants are *quoted* in press releases or
have signed documents, the defendants are properly held liable for
25 those statements, and the group pleading doctrine does not apply.
Although the Officer Defendants contest the accuracy of some of
26 these attributions, they do not appear to challenge the principle
that properly attributed quotations or signatures are not "group
27 pled" and may be a basis for liability. See Howard v. Everex
Systems, Inc., 228 F.3d 1057, 1061-62 (9th Cir. 2000)(discussing
28 the importance of holding signers of SEC documents responsible for
the statements they are signing).

1 establishes a presumption, for purposes of drafting a complaint,
2 that statements in "group-published information" such as
3 prospectuses, registration statements, annual reports, or press
4 releases are "the collective work of those individuals with direct
5 involvement in the day-to-day affairs of the company." In re
6 Silicon Graphics Sec. Litig., 970 F. Supp. 746, 759 (N.D. Cal.
7 1997) (quotations and citation omitted); In re GlenFed, Inc. Sec.
8 Litig., 60 F.3d 591, 593 (9th Cir. 1995).

9 The courts that have considered whether the group pleading
10 doctrine still stands in the wake of the PSLRA have come to
11 conflicting conclusions. The Ninth Circuit has not expressly
12 rejected the group pleading doctrine, and some courts still apply
13 it. See, e.g., In re Secure Computing Corp. Sec. Litig., 120 F.
14 Supp. 2d 810, 821-22 (N.D. Cal. 2000); In re BP Prudhoe Bay Royalty
15 Trust Sec. Litig., No. 06-1505, 2007 U.S. Dist. LEXIS 83007, 2007
16 WL 3171435 at *7 (W.D. Wash. 2007) (listing cases). The trend,
17 however, is against the continued viability of the doctrine. All
18 of the Circuit courts that have expressly considered whether group
19 pleading is compatible with the PSLRA have concluded that it is
20 not. See Winer Family Trust v. Queen, 503 F.3d 319, 334-37 (3d Cir.
21 2007); Makor v. Tellabs, 437 F.3d 588, 602-03 (7th Cir. 2006),
22 overruled on other grounds by Tellabs, 127 S. Ct. at 2511 n.6;
23 Southland Secs. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d
24 353, 365-66 (5th Cir. 2004).¹⁷ Additionally, several district

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26 ¹⁷Other Circuits have recognized the split in authority, but
27 have found it unnecessary to decide the issue in the context of the
28 particular case. See In re Hutchinson Tech., Inc. Sec. Litig., 536
F.3d 952, 961 n.6 (8th Cir. 2008); Miss. Public Employees Ret.
Sys., 523 F.3d 75, 93 (1st Cir. 2008); Phillips v. Scientific-

(continued...)

1 courts have refused to apply the group pleading doctrine after
2 Tellabs, and the majority of reported district court cases in the
3 Ninth Circuit appear to hold that the doctrine is no longer viable.
4 See, e.g., In re Impac Mortgage Holdings, Inc. Sec. Litig., 554 F.
5 Supp. 2d 1083, 1092 (C.D. Cal. 2008); In re Amgen Secs. Litig., 544
6 F. Supp. 2d 1009, 1036-37 (C.D. Cal. 2008); In re Hansen Natural
7 Corp. Sec. Litig., 527 F. Supp. 2d 1142, 1153-54 (C.D. Cal.
8 2007).¹⁸

9 Those courts that have found the group pleading doctrine in
10 conflict with the PSLRA have tended to rest their analysis on two
11 points. First, they emphasize the statute's use of "the
12 defendant." See In re Immune Response Sec. Litig., 375 F. Supp. 2d
13 983, 1029 (S.D. Cal. 2005); Southland, 365 F.3d at 364-65. That
14 is, the PSLRA expressly requires that the untrue statements or
15 omissions be set forth with particularity as to "the defendant,"
16 and that "with respect to each act or omission alleged to violate
17 this chapter, [the complaint must] state with particularity facts
18 giving rise to a strong inference that the defendant acted with the
19 required state of mind." 15 U.S.C. § 78u-4(b)(1),(2); Southland,
20 365 F.3d at 364-65 ("These PSLRA references to 'the defendant' may
21 only reasonably be understood to mean 'each defendant' in multiple

22
23 ¹⁷(...continued)
24 Atlanta, Inc., 374 F.3d 1015, 1018-19 (11th Cir. 2004) (declining
25 to rule, but acknowledging that "the most plausible reading in
26 light of congressional intent is that a plaintiff, to proceed
beyond the pleading stage, must allege facts sufficiently
demonstrating each defendant's state of mind regarding his or her
alleged violations").

27 ¹⁸District Courts in the Southern District of New York
28 continue to hold that the group pleading doctrine is viable. In re
BISYS Sec. Litig., 397 F. Supp. 2d 430, 439 n.42 (S.D.N.Y. 2005)
(listing cases).

1 defendant cases, as it is inconceivable that Congress intended
2 liability of any defendants to depend on whether they were all sued
3 in a single action or were sued each alone in several separate
4 actions."). Second, they argue that the continuation of the group
5 pleading doctrine would undermine the effectiveness of the PSLRA.
6 By enacting the PSLRA, Congress intended to impose heightened
7 pleading requirements for plaintiffs bringing fraud actions and, in
8 doing so, to erect a hurdle that would protect against
9 unmeritorious litigation. See Tellabs, 127 S. Ct. at 2508. If
10 courts were to allow plaintiffs to impute misstatements or intent
11 from one defendant to another, courts have reasoned, plaintiffs
12 would be able to skirt the heightened pleading standards by making
13 detailed allegations against one defendant and imputing those
14 statements to other defendants. Immune Response, 375 F. Supp. 2d at
15 1029-30. The courts have qualified this ban on group pleading,
16 however, by leaving open the possibility that, even when allegedly
17 problematic statements do not have a stated author, plaintiffs may
18 still meet the requirements of the PSLRA by alleging facts that
19 connect a particular defendant to an otherwise unattributed press
20 release. See Southland, 365 F.3d at 365 ("[C]orporate documents
21 that have no stated author or statements within documents not
22 attributed to any individual may be charged to one or more
23 corporate officers provided specific factual allegations link the
24 individual to the statement at issue.").

25 The Court is persuaded by this reasoning. Joining the
26 majority of other courts in this Circuit, the Court holds that
27 group pleading is no longer viable under the PSLRA. Thus, to the
28 extent Plaintiffs' allegations attributing statements to the

1 Officer Defendants rest solely on the group pleading doctrine, the
2 Complaint does not sufficiently plead liability for those
3 statements. While the group pleading doctrine is not fatal to
4 allegedly misleading statements in SEC filings signed by the
5 Officer Defendants, see Howard, 228 F.3d at 1061-62, the Officer
6 Defendants cannot be liable for the press releases, except to the
7 extent there are specific statements attributed to them, or the
8 press releases are otherwise connected to them, see Southland, 365
9 F.3d at 365. Because the Complaint alleges violations of
10 statements for each of the Officer Defendants that do not rest on
11 the group pleading doctrine, this holding does not preclude any of
12 the Officer Defendants from liability.

13 ii. Loan Quality and Underwriting

14 The Complaint alleges material misstatements regarding loan
15 quality and underwriting. In a number of documents, New Century is
16 described, for example, as having loans of "higher credit quality,"
17 "improved underwriting controls and appraisal review process," "a
18 strategy [of selecting borrowers with increasing credit scores],"
19 "strict underwriting and risk management disciplines," and "better
20 credit quality." (See, e.g., Compl. ¶¶ 343, 344, 347, 358, 361,
21 364, 387, 388, 405, 422, 443.) The Complaint ushers an array of
22 confidential witness statements that attest to New Century's
23 progressively riskier loan origination practices leading up to and
24 throughout the Class Period (Compl. ¶¶ 137-168); analyzes data
25 indicating rising defaults and delinquent loans (Compl. ¶¶ 120-
26 125); and sets forth data, that corroborates the witnesses, showing
27 a proliferation of high-risk loans such as adjustable-rate

28

1 mortgages provided to less-qualified borrowers (Compl. ¶¶ 126-
2 136.).

3 The pleadings adequately support a finding that these
4 statements were false and misleading when made. Two recent
5 district court cases in the Ninth Circuit have found similar
6 statements regarding loan quality and underwriting to provide a
7 basis for actionable securities law violations. In re Countrywide
8 Fin. Corp. Derivative Litig., 542 F. Supp. 2d 1160 (C.D. Cal.
9 2008); Atlas v. Accredited Home Lenders Holding Co., No.
10 07-CV-488H, 2008 U.S. Dist. LEXIS 3863, 2008 WL 80949, at *10 (S.D.
11 Cal. Jan. 4, 2008). This Court likewise agrees that these
12 statements are actionable, and that Plaintiffs' Complaint alleges
13 sufficient facts that the statements were material
14 misrepresentations of New Century's loan quality and underwriting
15 practices.

16 The Officer Defendants specifically challenge Plaintiffs'
17 allegations that statements about loan quality and underwriting
18 were false when made. The Officer Defendants first argue that
19 Plaintiffs are unable to allege material false statements when New
20 Century disclosed data to the public revealing the nature of its
21 loan portfolio and included cautionary language in stock offering
22 documents. It is also asserted in the Officer Defendants' and
23 Defendant Cole's motions, and more fully articulated in the
24 Underwriter Defendants' motion, albeit in the Section 11 context,
25 that Plaintiffs cannot challenge "forward-looking statements" and
26 that statements of "mere puffery" do not qualify as actionable
27 misstatements.

28

1 The "bespeaks caution" doctrine is a limit on defendant's
2 liability under the securities laws. This doctrine "developed to
3 address situations in which optimistic projections are coupled with
4 cautionary language . . . affecting the reasonableness of reliance
5 on and the materiality of those projections." In re Worlds of
6 Wonder Sec. Litig., 35 F.3d 1407, 1414 (9th Cir. 1994). The
7 PSLRA's safe harbor provision, which is the codified equivalent of
8 the "bespeaks caution" doctrine, see Employers Teamsters Local Nos.
9 175 & 505 Pension Trust Fund v. Clorox Co., 353 F.3d 1125, 1132
10 (9th Cir. 2004), provides that forward-looking statements cannot be
11 the basis for a securities fraud claim if: (1) the statement is
12 identified as forward looking and is accompanied by sufficient
13 cautionary statements; or (2) the person who made the
14 forward-looking statement did so without actual knowledge that the
15 statement was false or misleading. See 15 U.S.C. §
16 78u-5(c)(1)-(2).¹⁹ Similarly, statements that "are vague and
17 constitute run-of-the-mill corporate optimism on which no
18 reasonable investor would rely" fall into this category. Copper
19 Mountain, 311 F. Supp. 2d at 869.

20 The Court cannot determine as a matter of law that the PSLRA's
21 safe harbor provision is applicable to the statements regarding
22 loan quality and underwriting. A "forward-looking statement" "is
23 any statement regarding (1) financial projections, (2) plans and
24 objectives of management for future operations, (3) future economic
25 performance, or (4) the assumptions 'underlying or related to' any

26
27 ¹⁹It is appropriate to consider the application of the
28 In re Copper Mountain Sec. Litig., 311 F. Supp. 2d 857, 876 (N.D.
Cal. 2004).

1 of these issues." No. 84 Employer-Teamster Jt. Council Pension
2 Trust Fund v. Am. W. Holding Corp., 320 F.3d 920, 938 (9th Cir.
3 2003). The statements here, when made, seem to have concerned
4 explanation of New Century's then-current loan origination,
5 underwriting, and performance, at times in relation to the past.
6 Moreover, the references to generalized cautionary language
7 regarding the sub-prime industry appear largely unrelated to
8 whether the alleged statements here were false and misleading. The
9 inconclusive nature of these references cannot support dismissal at
10 the pleading stage. See Livid Holdings Ltd. v. Salomon Smith
11 Barney, Inc., 416 F.3d 940, 947 (9th Cir. 2005) ("Dismissal on the
12 pleadings under the bespeaks caution doctrine . . . requires a
13 stringent showing: There must be sufficient 'cautionary language or
14 risk disclosure [such] that reasonable minds could not disagree
15 that the challenged statements were not misleading."). The Court
16 therefore similarly cannot resolve application of the PSLRA safe
17 harbor provision in favor of Defendants at this time.

18 The Court also finds that the alleged statements cannot be
19 chalked up to "mere puffery." The allegations suggest New
20 Century's repeated assurances of strong credit quality and strict
21 underwriting practices. Even in the sub-prime world, there must be
22 a basis for distinction between loans to at-risk borrowers that
23 meet basic standards of good lending practice and loans that
24 plainly do not. Those standards may provide the measure for
25 evaluating Defendants' statements. Here, Plaintiffs offer New
26 Century's statements that it observed standards of high-quality
27 credit and underwriting, and set those statements against detailed
28 allegations of practices that utterly failed to meet those

1 standards. That is sufficient to plead false and misleading
2 statements.

3 iii. Financial Reporting and Internal Controls

4 The Court finds sufficient allegations of materially false and
5 misleading statements in financial reporting. The Complaint
6 details reported information on financial results, the repurchase
7 reserve, and valuation of residual interests, coupled with
8 disclosures in the 2005 10-K, and elsewhere, that those reports
9 were inaccurate. The disclosures support the allegation that the
10 financial reports were false and misleading when made. These
11 disclosures specifically mentioned a failure to track repurchase
12 claims and problems with internal controls as reasons for the
13 inaccurate statements. The Court similarly finds the disclosures
14 referenced in the Complaint sufficient to support the allegations
15 that Officer Defendants made material false and misleading
16 statements regarding the adequacy of internal controls during the
17 Class Period.

18 The Court does not consider the PSLRA safe harbor or the "mere
19 puffery" rule to bar Plaintiffs from pleading Defendants' liability
20 for alleged misrepresentations regarding internal controls and
21 accounting violations. There certainly may be a dispute whether
22 the statements of repurchase reserves and residual interests were
23 representations articulating the present state of historical facts,
24 or rather projections estimating a future state of affairs. That
25 dispute notwithstanding, Plaintiffs have alleged an understatement
26 of the repurchase reserve and an improper valuation of residual
27 interests that were both misrepresentations when made. The
28 Complaint details declining loan performance, an increase in

1 defaults, and a concomitant rise in repurchase claims, that were
2 baldly disregarded in setting the reserve and valuing residual
3 interests. This suggests misrepresentations that did not turn on
4 the outcome of future events. Based on Plaintiffs' allegations,
5 the rule barring liability for "forward-looking" statements or
6 "mere puffery" does not warrant dismissal at this time.

7 b. Scienter

8 The Ninth Circuit treats falsity and scienter as "a single
9 inquiry, because falsity and scienter are generally inferred from
10 the same set of facts." In re Read Rite Corp. Sec. Litig., 335
11 F.3d 843, 846 (9th Cir. 2003); Ronconi v. Larkin, 253 F.3d 423, 429
12 (9th Cir. 2001). This inquiry requires that a district court on a
13 motion to dismiss "determine whether particular facts in the
14 complaint, taken as a whole, raise a strong inference that
15 defendants intentionally or [with] deliberate recklessness made
16 false or misleading statements to investors." Ronconi, 253 F.3d at
17 429 (internal quotations omitted).

18 A district court must address competing inferences, whether
19 favorable to the plaintiff or not, that may be inferred from the
20 facts in the complaint. Daou, 411 F.3d at 1022. The inference of
21 scienter must be "more than merely plausible or reasonable - it
22 must be cogent and at least as compelling as any opposing inference
23 of nonfraudulent intent." Tellabs, 127 S. Ct. at 2504-05.
24 However, it need not be the "most plausible of competing
25 inferences." Id. at 2510. "To meet this pleading requirement [for
26 scienter], the complaint must contain allegations of specific
27 contemporaneous 'statements or conditions' that demonstrate the
28 intentional or the deliberately reckless false or misleading nature

1 of the statements when made." Ronconi, 253 F.3d at 432; cf.
2 Metzler Inv. GMBH v. Corinthian Colleges, Inc., 540 F.3d 1049,
3 1065-69 (9th Cir. 2008) (analyzing the scienter inferences with
4 respect to individual allegations, and then as a whole).

5 The Ninth Circuit recently addressed the PSLRA's scienter
6 requirement and the Supreme Court's opinion in Tellabs in South
7 Ferry LP, No. 2 v. Killinger, 542 F.3d 776 (9th Cir. 2008). In
8 light of Tellabs, the South Ferry court explained, a court
9 assessing whether a complaint raises a strong inference of scienter
10 considers the complaint as a whole, though a high level of detail
11 is still required. South Ferry, 542 F.3d at 784. That is, "Tellabs
12 permits a series of less precise allegations to be read together to
13 meet the PSLRA requirement, the prior holdings of [the Ninth
14 Circuit in] Silicon Graphics, Vantive, and Read-Rite
15 notwithstanding." Id. With respect to allegations relying on an
16 inference of scienter from knowledge of the company's core
17 operations, the South Ferry court explained that

18 [A]llegations regarding management's role in a company may be
19 relevant and help to satisfy the PSLRA scienter requirement in
20 three circumstances. First, the allegations may be used in any
21 form along with other allegations that, when read together,
22 raise an inference of scienter that is "cogent and compelling,
23 thus strong in light of other explanations." . . . Second,
24 such allegations may independently satisfy the PSLRA where
25 they are particular and suggest that defendants had actual
26 access to the disputed information Finally, such
27 allegations may conceivably satisfy the PSLRA standard in a
28 more bare form, without accompanying particularized

1 allegations, in rare circumstances where the nature of the
2 relevant fact is of such prominence that it would be "absurd"
3 to suggest that management was without knowledge of the
4 matter.

5 Id. at 785-86 (internal citations omitted).

6 The parties dispute the nature of the Court's inquiry into
7 scienter at the 12(b)(6) stage. The Officer Defendants urge the
8 Court to analyze scienter separately as to each violation and each
9 defendant. Plaintiffs emphasize the language in Tellabs that "the
10 court's job is not to scrutinize each allegation in isolation but
11 to assess all the allegations holistically." 127 S. Ct. at 2511.
12 As noted above with respect to group pleading, see
13 § II(E)(1)(a)(i), supra, the PSLRA's heightened pleading standard
14 appears to require individualized allegations as to scienter. 15
15 U.S.C. § 78u-4(b)(2).²⁰ The Court does not read Tellabs as
16 excusing Plaintiffs from the plain requirements of the statute that
17 the complaint shall "with respect to each act or omission alleged
18 to violate this chapter, state with particularity facts giving rise
19 to a strong inference that the defendant acted with the required

20
21 ²⁰The jurisprudence on the group pleading doctrine addresses
22 both whether a statement may be attributed to a particular
23 defendant and whether scienter may be imputed from one defendant to
24 another. As the Court's discussion of the group pleading doctrine
25 suggests, for the most part, courts have found that group
26 allegations as to scienter run afoul of the particularity
27 requirements of the PSLRA. See In re Lockheed Martin Corp. Sec.
28 Litig., 272 F. Supp. 2d 928, 936 (C.D. Cal. 2002) ("Under no
circumstances does the group-published information doctrine relieve
plaintiffs of their burden to pled scienter under sub-paragraph 2
of the Act."). The discussion of the core operations doctrine in
South Ferry does not conflict with the Court's analysis on group
pleading. The core operations doctrine is distinct from group
pleading, but some of the analytical points - e.g., imputing
knowledge from the defendant's position in the company and the
nature of the information - overlap.

1 state of mind." Id. That is not to say, however, that, in the
2 context of a holistic analysis, allegations will only be relevant
3 to scienter for one statement or one type of statement. Rather,
4 the Court reads the language in Tellabs as cautioning courts to
5 view the scienter allegations holistically with respect to each
6 allegedly violative act committed by each defendant. Below, the
7 Court considers Plaintiffs' scienter allegations for each of the
8 three types of allegedly fraudulent acts. The Court finds that
9 Plaintiffs have sufficiently alleged facts giving rise to a strong
10 inference that the Officer Defendants were at least deliberately
11 reckless in making misrepresentations as to loan quality, internal
12 controls, and various financial statements.²¹

13
14
15 ²¹In the interest of a clearer analysis, the Court discusses
16 scienter of the Officer Defendants together. The Court finds,
17 however, that the allegations are sufficient to create a strong
18 inference that *each* of the Officer Defendants acted with scienter.
19 In their papers and at oral argument, the Officer Defendants argued
20 that the Complaint does not make sufficient connections between
21 each of the Officer Defendants and knowledge of information
22 contrary to what their statements conveyed. The Court disagrees.
23 The Complaint perhaps most clearly connects knowledge that
24 statements were false and misleading to Defendants Morrice and
25 Dodge. (E.g., Compl. ¶¶ 179 & n.24, 189 (loan quality,
26 underwriting, and internal controls); id. ¶¶ 75-78, 491, 494
27 (financial misstatements).) Other allegations, however, connect
28 knowledge of contemporaneous conditions and contrary knowledge to
all four Officer Defendants. The Examiner's Report defines Senior
Management to include Cole, Gotschall, Morrice, and Dodge from
2004-2006. (Compl. at 56 n.10; e.g., BER 77-78.) For example,
relying on and quoting from the Examiner's Report, the Complaint
alleges that New Century's Senior Management "knew from multiple
data sources that its loan quality was problematic, starting no
later than 2004." (Compl. ¶ 175.) Moreover, the Complaint alleges
that loan quality was crucial to the core operations of the
company, with which these central officers were familiar. (Compl.
¶ 344.) See South Ferry, 542 F.3d at 785. With respect to
internal controls, the Complaint alleges that Senior Management
knew about problems with its internal controls, and represented to
KPMG that it would fix them. (Compl. ¶¶ 194-96; 486-87.)

1 i. Loan Quality and Underwriting; Internal
2 Controls

3 The Court finds that Plaintiffs' Complaint creates a
4 compelling inference that the Officer Defendants were deliberately
5 reckless in their public statements regarding loan quality and
6 underwriting. First, the confidential witness statements describe
7 a staggering race-to-the-bottom of loan quality and underwriting
8 standards as part of an effort to originate more loans for sale
9 through secondary market transactions. The witnesses catalogue an
10 explosive increase in risky loan products, including interest-only
11 loans,²² stated income loans, and adjustable-rate loans, and a
12 serious decline in loan quality and underwriting. The Court finds
13 that these witnesses are described with sufficient particularity
14 and that "adequate corroborating details" for their statements are
15 provided. See Daou, 411 F.3d at 1015.

16 Several witnesses portray an underwriting system driven by
17 volume and riddled with exceptions. They state that the goal was
18 to "push more loans through" (Compl. ¶¶ 138, 139, 151-154), that
19 "there was always someone to sign off on any loan" (Compl. ¶ 140),
20 that nearly any loan was approved to meet its sales projections
21 (Compl. ¶¶ 141, 142), and that exceptions were commonly made for
22 the otherwise unqualified (Compl. ¶¶ 140, 144, 152, 155). There
23 are specific instances of loose standards, as when an employee
24 recommended denial of a loan application but higher-level managers

26 ²²For example, a former Vice President states that New
27 Century, which always had a stated income loans program for self-
28 employed borrowers, expanded the program to wage-earners starting
in 2004 and 2005. (Compl. ¶ 137.)

1 repeatedly approved those loans, (Compl. ¶ 144), or when
2 underwriters allowed rejected loans, usually because borrowers'
3 incomes were too low, a second chance and approved the formerly
4 rejected loans. (Compl. ¶ 146.) There is testimony that
5 instructions, according to managers, came from the corporate
6 officers (Compl. ¶ 146), and that officers had access to
7 information on the effects of these practices, including the rising
8 defaults (Compl. ¶ 154). There are also indications that the
9 compensation for sales reinforced the disregard for standards and
10 quality as volume was linked to reward.

11 The Examiner's Report found knowledge within high-levels of
12 the company of its declining loan quality and underwriting as early
13 as 2004. (Compl. ¶ 177.) The Report mentions the internal reports
14 by New Century's Senior Management and negative internal audits
15 that acknowledged serious problems with loan quality and
16 underwriting, as well as the poor performance of the company's
17 high-risk products, and concludes that the New Century failed to
18 respond to "red flags." (Compl. ¶ 179.) It is as plausible an
19 inference as any other that the Officer Defendants were aware of
20 the alleged pervasive company-wide practice of issuing loans of
21 poor quality without complying with any basic set of underwriting
22 standards. Moreover, the image of a company's falling standards
23 coincide with allegations supported by data of a rise in both
24 delinquency rates and repurchase claims that was also disclosed in
25 internal documentation. (Compl. ¶¶ 126-136, 173-190.)

26 These same allegations also give rise to a strong inference of
27 scienter with respect to alleged misstatements regarding internal
28 controls in the company. Moreover, the Complaint discloses prior

1 knowledge of problems with internal controls from before the time
2 of the alleged misrepresentations, (Compl. ¶¶ 486-87), and of the
3 growing backlog in repurchase claims, (Compl. ¶¶ 75, 77, 92-93).
4 Despite these causes for concern, the Officer Defendants repeatedly
5 certified the internal controls in Sarbanes-Oxley certifications.
6 (Compl. ¶¶ 348-49, 362-63, 377-78, 390-91, 409-410, 426-27, 444-
7 45.)

8 The Complaint may not disclose the kind of "smoking gun
9 evidence" that establishes a clear intent to deceive, but neither
10 does it need to do so. Tellabs, 127 S. Ct. at 2510. The
11 allegations are sufficient to infer a deliberately reckless set of
12 statements telling the public one thing when New Century was doing
13 something quite different - the loans were of poor, not great,
14 quality; the underwriting was all but absent, not strict; and the
15 internal controls were slack rather than searching. The Examiner's
16 Report, to the extent that it does not explicitly find fraud, does
17 not preclude Plaintiffs from pleading fraud. The inference of
18 deliberate recklessness as to false statements regarding loan
19 quality and underwriting is at least as compelling as inferring
20 that the Officer Defendants were simply unaware of New Century's
21 practices when the statements were made, or taken by surprise when
22 the market took an unexpected turn for the worse.

23 ii. GAAP Violations, the Repurchase
24 Reserve, Valuation of Residual
25 Interests, and ALL

26 The Complaint alleges scienter with respect to several
27 accounting misrepresentations, including misstatements regarding
28 the adequacy of the repurchase reserve and the valuation of

1 residual interests. "Violations of GAAP standards can . . .
2 provide evidence of scienter." Daou, 411 F.3d at 1016. For GAAP
3 violations to serve as a predicate for scienter, a Plaintiff must
4 allege "enough information so that a court can discern whether the
5 alleged GAAP violations were minor or technical in nature, or
6 whether they constituted widespread and significant inflation of
7 revenue." Id. at 1017.

8 The Complaint alleges that the Officer Defendants represented
9 that the reserve was adequate when the repurchase reserve was
10 actually inadequate to cover the growing backlog of repurchase
11 claims and later disclosures admitted the inadequacy of the
12 reserve. This backlog, according to the Examiner's Report, was "no
13 secret" and "general knowledge" within the company's accounting,
14 finance, and secondary marketing departments. In a September 8,
15 2006 press release, however, Defendant Morrice referred to the rise
16 in loan payment defaults as merely "modest", when contemporaneously
17 available information indicated a significant rise in repurchase
18 claims and thus suggested otherwise. Further, the Officer
19 Defendants attested to the reserve's adequacy in accordance with
20 GAAP. There is confidential witness testimony that the repurchase
21 claims backlog was intentionally designed to delay payment of
22 repurchase claims to inflate earnings in an effort to "game the
23 system." (Compl. ¶¶ 75, 77.)

24 Having reviewed the detailed allegations, the Court finds that
25 the Complaint contains particularized allegations of scienter with
26 respect to the accounting improprieties at New Century. The
27 allegations indicate an acute awareness within New Century of the
28 backlog making it highly unlikely that officers were unaware that

1 the reserve was inadequate to cover the growing number of
2 repurchase claims. These allegations of reckless accounting
3 violations are bolstered by the particularized allegations of
4 scienter in statements about loan quality and underwriting, which
5 suggest that the Officer Defendants were similarly reckless in
6 appreciating the gravity of the repurchase claims backlog and the
7 inadequacy of the reserve.²³

8 The Complaint additionally alleges that the Officer Defendants
9 misstated the value of residual interests in a number of SEC
10 filings. The Court similarly finds that alleged GAAP violations
11 related to residual interests, along with allegations of the
12 backlog, are sufficient for a strong inference of scienter.
13 Further, the fact that the new CEO, Tajvinder Bindra discovered the
14 accounting violations within months of taking the position is a
15 strong indication that these accounting violations were obvious
16 enough that a new officer found them quickly. The allegations of a
17 misstated repurchase claims reserve, along with misrepresentations
18 of the residual interests' value, depict a profound effort to mask
19 New Century's declining loan performance. Therefore, the Court
20 also finds that Plaintiffs have created a compelling inference that
21 the Officer Defendants were deliberately reckless in their
22 misstatements regarding the repurchase reserve and the valuation of
23 residual interests.

24 The Complaint, however, fails to adequately allege scienter
25 with respect to alleged misrepresentations of the ALL. The

26 _____

27 ²³The Court similarly finds that the allegations support a
28 strong inference of scienter as to the unexplained combination of
two unrelated reserves and the questionable methods utilized in
setting the ALL.

1 Examiner concluded that any accounting violations in setting the
2 ALL actually reduced earnings. The Complaint does not dispute this
3 finding. Even though there are allegations that the ALL was
4 misstated due to GAAP violations, these alleged violations cannot
5 support an inference of fraudulent intent to inflate earnings in an
6 effort to misrepresent New Century's financial condition in a
7 positive light. The reduction in earnings actually suggests
8 otherwise.

9 iii. KPMG Audit

10 The Officer Defendants argue that their reliance on KPMG's
11 audit opinion precludes a strong inference of scienter. "Although
12 a clean outside audit opinion does not rule out a finding of
13 scienter, 'a clean audit may be considered in determining whether
14 there is scienter.'" In re Wet Seal, Inc., 518 F. Supp. 2d 1148,
15 1166 (C.D. Cal. 2007) (citations omitted). The Court does not,
16 however, consider the KPMG audit opinion to warrant a different
17 conclusion than reached above.

18 The Officer Defendants do not point to specific references in
19 the KPMG audit opinion that bear on their alleged recklessness in
20 making statements regarding loan quality or underwriting. As for
21 any reliance on KPMG's opinion with respect to accounting
22 violations, the Court does not consider the existence of the audit
23 to preclude a strong inference of scienter under the circumstances
24 here. The Complaint alleges both serious accounting violations by
25 the Officer Defendants and serious auditing violations by KPMG.
26 Especially in the presence of allegations that the officers and the
27 auditor were complicit in the ultimate misrepresentations of New
28 Century's financial condition, "[t]he fact that [New Century's]

1 independent auditor may have approved the accounting methods will
2 not shield [the officers] from liability for deception such methods
3 may have caused." See Marksman Partners, L.P. Chantal Pharm.
4 Corp., 927 F. Supp. 1297, 1314 n.13 (C.D. Cal. 1996). The extent
5 of the Officer Defendants' reliance, the scope of any independent
6 obligations for accounting violations, and whether they were
7 reckless in a spite of the audit opinion remain open questions at
8 this stage. The Court therefore does not consider the audit
9 opinion to undermine the particularity with which Plaintiffs have
10 alleged scienter.

11 iv. Stock Sales, Compensation, and Motive
12 Allegations

13 The pleading of insider trading may support a strong
14 inference of scienter. Here, the Complaint discloses a number of
15 stock sales by the Officer Defendants in or around the Class
16 Period. A court must address whether the allegations suggest a
17 compelling inference that "suspicious" sales of stock occurred that
18 were "dramatically out of line with prior trading practices at
19 times calculated to maximize the personal benefit from undisclosed
20 inside information." Silicon Graphics, 183 F.3d at 986. A court
21 will consider the following factors: (1) the amount and percentage
22 of shares sold by insiders; (2) the timing of the sales; and (3)
23 whether the sales were consistent with the insider's prior trading
24 practices. Id. A motive to defraud based on compensation
25 incentives such as bonuses and dividends also may strengthen an
26 inference of scienter. See Am. West, 320 F.3d at 944.

27 The Complaint alleges that the Officer Defendants sold stock
28 for proceeds of \$53 million during the Class Period. These sales

1 accounted for 77% of Defendant Dodge's total holdings, 37% of
2 Defendant Gotschall's total holdings, and 31% of Defendant Cole's
3 total holdings.²⁴ (Compl. ¶¶ 507-514.) The Complaint further
4 alleges that the Officer Defendants were beneficiaries of the
5 inflated earnings caused by their misrepresentations, as they
6 received dividends of \$50 million during the Class Period and also
7 bonuses that the Examiner's Report found were 300% higher than they
8 should have been because based on the inflated earnings rather than
9 New Century's actual financial performance. (Compl. ¶¶ 502-505.)

10 The Officer Defendants contend that the allegations contain
11 scant reference to their prior trading history, and do not indicate
12 a substantial unloading of their holdings. More specifically, the
13 Officer Defendants provide explanations for the sales: Dodge's
14 sales were less than estimated by Plaintiffs; Morrice only made two
15 sales that were less than 10% of his holdings; and Gotschall's
16 sales were part of a plan for retirement and pursuant to a 10b5-1
17 plan. Defendant Cole, in his motion, also links his sales to
18 retirement in early 2006 and notes that many of his sales occurred
19 before the Class Period. All of the Officer Defendants argue that
20 they held onto a substantial portion of shares for which they
21 suffered losses. They also provide explanations for their bonuses
22 and dividends.

23 The Court agrees that the Officer Defendants' maintenance of
24 substantial stock holdings for which they suffered losses upon New
25 Century's collapse cut against any insider trading.
26 Nevertheless, the allegations of insider stock sales, dividends,

27
28 ²⁴There is no specific allegation calculating the percentage
of total holdings sold in stock sales by Defendant Morrice.

1 and options at least provides some additional support for the
2 otherwise strong inference of scienter. Notably, the timing of the
3 10b-5 plans, several years after they became available, at least
4 raises the question precisely why there was a delay in creating
5 those plans, and why they were formed during the Class Period.
6 Although not the strongest set of allegations of insider trading
7 and suspicious compensation, the Court finds that the motive
8 allegations offer minimal additional support for a conclusion of
9 scienter.

10 v. Summary

11 The Court finds that the pleadings support a strong inference
12 of scienter.²⁵ The Court, at this stage, does not view the
13 alternative inferences to be any more compelling than the inference
14 that the Officer Defendants were deliberately reckless in their
15 misrepresentations to the public. The only exception are
16 statements regarding the ALL.

17 2. Section 20(a) of the Exchange Act

18 Section 20(a) imposes joint and several liability on persons
19 who directly or indirectly control a violator of the securities
20 laws. It provides

21 Every person who, directly or indirectly, controls any person
22 liable under any provision of this chapter or of any rule or
23 regulation thereunder shall also be liable jointly and
24 severally with and to the same extent as such controlled

25

26 ²⁵A plaintiff must properly allege reliance and loss causation
27 to state a claim under section 10(b) or Rule 10(b)(5). Here, the
28 Complaint contains allegations of loss causation. The Officer
Defendants do not raise a challenge to Plaintiffs' allegations of
loss causation.

1 person . . . is liable, unless the controlling person acted in
2 good faith and did not directly or indirectly induce the act
3 or acts constituting the violation or cause of action.
4 15 U.S.C. § 78t(a). A prima facie case of control person liability
5 requires evidence (a) that a primary violation of the securities
6 laws occurred and (b) that defendant directly or indirectly
7 controlled the person or entity committing the primary violation.
8 See, e.g., Paracor Finance, 96 F.3d at 1161.

9 The Court has found that the pleadings sufficiently allege a
10 primary violation of section 10(b) and Rule 10(b)(5) against each
11 of the Officer Defendants. The Complaint alleges that the Officer
12 Defendants controlled the operation of New Century, and that this
13 caused it to violate section 10(b) and Rule 10(b)(5). This
14 sufficiently pleads control person liability under section 20(a).

15 F. Plaintiffs' Claims Under Section 10(b) of the Exchange
16 Act Against Defendant KPMG

17 1. Materially False and Misleading Statements

18 To reiterate, the Complaint alleges that KPMG's audit opinion
19 of New Century's 2005 year-end financial statements and internal
20 controls as of December 31, 2005 - incorporated in the Series B
21 stock offering - contained material misstatements in violation of
22 the Public Company Accounting Oversight Board ("PCAOB") standards.
23 (See supra Part I.E.3.) The Court has reviewed the allegations in
24 the Complaint, and concludes that it satisfactorily sets forth
25 allegations that KPMG made material misrepresentations in its audit
26 opinion. KPMG does not challenge Plaintiffs' section 10(b) claim
27 on these grounds, however. KPMG focuses on scienter and loss
28 causation.

1 2. Scienter

2 To plead scienter allegations against an auditor, the Ninth
3 Circuit has held that a plaintiff must show "more than a
4 misapplication of accounting principles,' and allege with
5 particularity that the auditor's "accounting practices were so
6 deficient that the audit amounted to no audit at all, or an
7 egregious refusal to see the obvious, or to investigate the
8 doubtful, or that . . . no reasonable accountant would have made
9 the same decisions[.]" DSAM Global Value Fund v. Altris Software,
10 288 F.3d 385, 390 (9th Cir. 2002) (quoting In re Software Toolworks
11 Inc., 50 F.3d 615, 627-28 (9th Cir. 1994).

12 a. Repurchase Reserve

13 The Complaint alleges that KPMG was aware of weaknesses in New
14 Century's internal controls prior to its 2005 audit because it
15 noted in its 2004 audit that the company failed to adopt
16 appropriate procedures for calculation of the repurchase reserve.
17 (Compl. ¶¶ 523-524.) In working on the 2005 audit, one of KPMG's
18 junior auditors assigned to New Century specifically requested
19 information on outstanding repurchase claims. She learned that
20 approximately \$188 million in outstanding requests existed as of
21 year-end 2005. KPMG, while noting in its paperwork that it was
22 aware of the approximate amount of outstanding repurchase claims,
23 did not consider this information in determining the adequacy of
24 the reserve. KPMG endorsed a reserve amount of \$70 million despite
25 the significantly larger amount outstanding for repurchase claims.
26 (Compl. ¶ 227.) Moreover, the Examiner found that KPMG failed to
27 perform even "minimal" testing in making its reserve calculation,
28 and that such tests would have revealed its material errors.

1 (Compl. ¶¶ 228-229.) These failures resulted in inflation of \$21
2 million in New Century's 2005 year-end financial statements.

3 (Compl. ¶ 99.)

4 Here, the Court finds that the Complaint alleges
5 particularized facts of scienter. If the allegations are true,
6 KPMG knew that New Century was utilizing a faulty method for
7 calculating its reserve and that its repurchase claims far outpaced
8 its reserve amount, but did nothing to correct the deficiency. The
9 absence of a meaningful investigation into the flawed accounting
10 methods used in setting the reserve supports a strong inference of
11 scienter. See Ponce v. SEC, 345 F.3d 722, 733-34 (9th Cir. 2003).
12 Moreover, the absence of any explanation for its failure to correct
13 New Century's severely underfunded reserve in the face of "red
14 flags" further supports a strong inference of scienter. See, e.g.,
15 Homestore.com, Inc. Sec. Litig., 252 F. Supp. 2d at 1044.

16 The Court is not persuaded that the Examiner's finding that
17 there was no evidence of intentional misrepresentation to be
18 dispositive at the pleading stage. The Court is required to make
19 an independent investigation of any facts obtained through
20 discovery. Moreover, it is matter for summary judgment whether the
21 repurchase claims backlog was not material until 2006 as asserted
22 by KPMG.

23 b. Residual Interests

24 Similarly for residual interests valuation, the Complaint
25 alleges that KPMG was aware of internal control deficiencies
26 regarding New Century's methods for determining the value of
27 residual interests based upon its findings in its 2004 audit.

28 (Compl. ¶ 231.) During 2005 and in connection with the 2005 audit,

1 KPMG internal specialists raised "red flags" regarding New
2 Century's aggressively low discount rate and its potential to
3 inflate valuations. (Compl. ¶ 224) The internal specialists also
4 considered New Century's documentation insufficient for the audit
5 team to proceed in evaluating the valuations, but the team
6 nevertheless proceeded in finding the valuations adequate. The
7 Complaint also refers to New Century's outdated valuation models.
8 This resulted in an overstatement of residual interests of
9 approximately \$14 million (Compl. ¶ 232.)

10 Viewing the allegations as a whole, the Court again finds a
11 compelling inference of scienter. The Complaint contains
12 particularized allegations of KPMG's willful failure to consider
13 the opinions of internal specialists when "red flags" were raised
14 about New Century's low discount rate and valuation models. The
15 allegations support an awareness on the part of KPMG's audit team
16 that internal controls were problematic, but the team nevertheless
17 accepted incomplete documentation in reaching its determinations.
18 The allegations, therefore, suggest more than a simple
19 mistake-willful ignorance of a company's valuation methods may
20 support a strong inference of scienter. Here, Plaintiffs'
21 Complaint meets this standard. KPMG's suggestion that the audit
22 team gave due consideration to its internal specialists opinions
23 may ultimately establish that any misrepresentations in the audit
24 were not reckless. That is a matter properly determined at summary
25 judgment.

26 c. Hedge Accounting

27 The Complaint describes a hedge accounting dispute between a
28 KPMG internal specialist and an audit team partner named Donovan

1 that arose in 2005. (Compl. ¶¶ 225-226.) The specialist objected
2 to New Century's accounting method, and told Donovan that he
3 refused to approve the audit until he was able to review particular
4 documentation. Before the specialist had the opportunity to review
5 the documents, Donovan informed New Century's Audit Committee that
6 the dispute would be resolved. Donovan also sent an e-mail to the
7 specialist in which he expresses dismay that the specialist was
8 raising questions. It was only after the audit was completed that
9 the specialist obtained the documentation. The specialist found an
10 accounting violation that resulted in a misstatement of several
11 million dollars. (Id.)

12 The allegations support an inference that KPMG was aware of a
13 specialist's objection to a particular accounting method, but
14 nevertheless certified the audit without fully exploring the merits
15 of this objection. Yet KPMG points to the attention that was given
16 to the hedge accounting dispute. KPMG's Department of Professional
17 Practice ("DPP") attempted to resolve the disagreement, and the DPP
18 ultimately authorized issuance of the audit after further internal
19 discussion of the issue.

20 The Court, while finding that KPMG supplies an alternative
21 inference that it made a reasoned judgment whether to issue the
22 audit opinion in spite of the dispute, cannot conclude that
23 Plaintiff has failed to plead at least an equally compelling
24 inference of scienter as to the hedge accounting misstatement.
25 KPMG may be read to have made a reasoned judgment, but also may be
26 interpreted to have intentionally accepted the audit opinion
27 without confirming whether the basis for the specialist's
28 objections were valid. The allegations, along with KPMG's

1 arguments, support the notion that the issuance of the audit
2 opinion without complete resolution of the objection was a knowing
3 decision. As opposed to KPMG's suggestion of a reasoned judgment,
4 Plaintiffs offer an equally compelling inference of a deliberate
5 choice not to verify the merits of the specialist's objections,
6 which appears to have been valid.

7 d. ALL

8 Based on the Court's earlier discussion of the ALL
9 allegations, the Court concludes that the allegations do not
10 support a claim of scienter where the ALL did not inflate earnings
11 nor misrepresent New Century's financial health in a positive
12 light.

13 e. Mortgage Servicing Rights and Goodwill

14 As with other areas already discussed, the Complaint suggests
15 that KPMG internal specialists recommended an independent valuation
16 of the mortgage servicing rights, but the audit team did not do so,
17 despite the fact that New Century had not conducted a proper
18 valuation of those rights. (Compl. ¶ 233.) Again, this allegation
19 supports a strong inference of a deliberate willingness to state
20 that there was GAAP compliance when there clearly was not. (See
21 id.) As for goodwill testing, the Examiner found that KPMG simply
22 failed to obtain the necessary evidence to even audit the testing.
23 (Id.) At this stage and in the context of strong inferences of
24 scienter on several grounds, the Court also finds that Plaintiffs
25 have adequately alleged a strong inference with respect to
26 goodwill.

27 f. Summary

28

1 The Court concludes that Plaintiffs have stated particularized
2 facts that give rise to a strong inference of scienter as to KPMG's
3 alleged misrepresentations in the 2005 audit opinion. The only
4 exception at this stage are statements regarding the ALL. The
5 Court notes that Plaintiffs have linked the allegations regarding
6 KPMG's knowledge of internal control deficiencies with the
7 allegations of misrepresentations. Moreover, the allegations
8 regarding inadequate and inexperienced staff, and the rapid
9 discovery of the alleged accounting violations are further support
10 for the several strong inferences that KPMG's audit contained
11 deliberately reckless misstatements regarding New Century's
12 accounting practices.

13 3. Loss Causation

14 A plaintiff in a § 10(b) case must also plead loss causation.
15 As the Supreme Court explained the plaintiff's pleading burden in
16 Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005), a plaintiff must
17 provide allegations of loss causation that show investors paid an
18 artificially inflated price for stock and that the stock price fell
19 "after the truth became known" regarding the defendant's material
20 misrepresentations. 544 U.S. at 344. A plaintiff satisfies this
21 pleading requirement by alleging "some indication of the loss and
22 the causal connection plaintiff has in mind." Daou, 411 F.3d at
23 1026; see Dura, 544 U.S. at 347 (suggesting that Rule 8(a)(2)
24 notice pleading applies and noting that "it should not prove
25 burdensome for a plaintiff who has suffered an economic loss to
26 provide a defendant with some indication of the loss and the causal
27 connection that the plaintiff has in mind."). In raising the
28 affirmative defense of "negative causation," a defendant asserts

1 that the alleged misrepresentation did not cause a plaintiff's
2 damages. See 15 U.S.C. § 77k(e).

3 KPMG argues that Dura requires Plaintiffs to plead a fact-for-
4 fact corrective disclosure to sufficiently allege loss causation.
5 The law does not clearly support this interpretation. As stated by
6 one court, the Supreme Court in Dura "did not . . . indicate what
7 form a disclosure must take, how completely it should reveal
8 previously misrepresented or concealed information, or how
9 specifically it must refer to that information." In re Motorola
10 Sec. Litig., 505 F. Supp. 2d 501, 540 (N.D. Ill. 2007). Rather,
11 Plaintiffs must plead facts giving rise to a reasonable inference
12 that the market became aware of the misrepresentations.

13 Corinthian, 540 F.3d at 1064. The truth need not be revealed to
14 the market through a single, complete disclosure. See Daou, 411
15 f.3d at 1026-27; accord Freeland v. Iridium World Commc'ns, Ltd.,
16 233 F.R.D. 40, 47 (D.D.C. 2006)("[R]eading Dura to require proof of
17 a complete, corrective disclosure would allow wrongdoers to
18 immunize themselves with a protracted series of partial
19 disclosures."). Courts have cast doubt, however, on whether the
20 announcement of an investigation can be sufficient as a matter of
21 law to plead loss causation. See Hansen, 527 F. Supp. 2d at 1162
22 (suggesting that a disclosure of wrongdoing is required); Weiss,
23 527 F. Supp. 2d at 945-48 (only announcement was a voluntary
24 investigation that did not disclose any facts to the market).

25 Here, Plaintiffs allege that KPMG's statements in its audit
26 opinion caused their damages. KPMG raises the "negative causation"
27 defense. It argues that the chain of events leading to the decline
28 of Plaintiffs' stock did not implicate disclosure of any

1 misstatements by KPMG. Specifically, the only relevant KPMG
2 representations occurred in its 2005 audit opinion concerning New
3 Century's 2005 financial statements; the February 7, 2007
4 disclosures concerned the 2006 financial statements for which KPMG
5 did not provide an audit opinion; the March 2, 2007 disclosures did
6 not clearly correct a KPMG statement; and thus, the decline in
7 Plaintiffs' stock was the result of disclosures related to
8 financial statements that were not reviewed by KPMG. Therefore,
9 KPMG argues, Plaintiffs cannot plead loss causation as a matter of
10 law.

11 Plaintiffs do not argue that the February 7, 2007 disclosures
12 concerned KPMG's statements.²⁶ However, Plaintiffs argue, and
13 plead, that additional disclosures on March 2, 2007 concerned
14 KPMG's opinion regarding the 2005 financial statements. On that
15 date, New Century announced that the Audit Committee of the Board
16 of Directors had "initiated its own independent investigation into
17 the issues giving rise to the Company's need to restate its 2006
18 interim financial statements, as well as issues pertaining to the
19 Company's valuation of residual interests in securitizations in
20 2006 and prior periods." (Compl. ¶ 464.) Plaintiffs emphasize
21 that this reference to "prior periods" can be read to refer to the
22 2005 financial statements reviewed by KPMG. Also, Plaintiffs
23 explain that this Audit Committee decision followed a February 2007
24 report by KPMG to the Committee. Since the most significant
25 decline in stock price occurred after the March 2, 2007

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27 ²⁶KPMG cannot be liable for losses that occurred prior to
28 disclosures that implicated its misrepresentations. See Daou, 411
F.3d at 1026-27.

1 disclosures, Plaintiffs maintain that they have sufficiently pled
2 loss causation.

3 The Court finds that Plaintiffs have sufficiently pled loss
4 causation. The March 2, 2007 disclosure indicates the need to
5 reevaluate at least certain financial statements in "prior
6 periods." This includes the 2005 financial statements reviewed by
7 KPMG. As a significant stock decline followed this disclosure,
8 Plaintiffs have properly alleged loss causation. KPMG frames the
9 reference to "prior periods" as merely a two-word passing reference
10 to an investigation. (KPMG's Mot. at 12.) Plaintiffs' allegations
11 suggest, however, that the import of the reference to "prior
12 periods" was not so limited, particularly in the context of the
13 other disclosures. Unlike the disclosure of an investigation in
14 Weiss, for example, the disclosure of New Century's investigation
15 into prior periods was made in the context of other information
16 about New Century's financial state. (Compl. ¶¶ 458-65.) See
17 Weiss, 527 F. Supp. 2d at 947.²⁷ Plaintiffs appear to allege that
18 the relationship between the disclosed problems with the 2006
19 statements and the 2005 misstatements were integrally overlapping
20 such that they had become known to the market. Admittedly, the
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22 ²⁷The Court considers the allegations here to be distinct from
23 those the Ninth Circuit found inadequate in Corinthian. In
24 Corinthian, the court was troubled by the suggestion that the
25 market could become aware through (1) the announcement of a
26 location-specific investigation and (2) a company-issued
27 "euphemism." 540 F.3d at 1063-64. The plaintiffs had argued that
28 the disclosure that there would be "higher than anticipated
attrition" was a "euphemism" for an admission of the company's
broad alleged fraud. Id. at 1064. In this case, however, the
disclosures that allegedly caused the drop in stock price were
significantly more detailed in suggesting how previous statements
were problematic than simply a suggestion that revenue might be
lower than anticipated.

1 connection between the March 2, 2007 disclosure and KPMG's
2 allegedly misleading statements may be found too attenuated, or the
3 existence of intervening causes may be too significant, for
4 Plaintiffs to establish loss causation. Those are factual
5 questions that this Court does not resolve on a 12(b)(6) motion.
6 The Complaint sufficiently provides KPMG with an "indication of the
7 loss and the causal connection that [Plaintiffs] [have] in mind."
8 Dura, 544 U.S. at 347. Thus, the Court considers Plaintiffs'
9 allegations of loss causation adequate.

10 G. Plaintiffs' Claims Under Section 11 and Section 15 of the
11 Securities Act

12 Plaintiffs bring claims under Section 11 of the Securities Act
13 against the Officer Defendants, Director Defendants, Defendant
14 KPMG, and the Underwriter Defendants. Plaintiffs also bring claims
15 under Section 15 of the Securities Act for control person liability
16 against the Officer Defendants.

17 A defendant may be liable for violations of Section 11 for
18 innocent or negligent misstatements or omissions of material fact
19 in a securities registration statement. 15 U.S.C. § 77k(a). Those
20 against whom a plaintiff may bring a Section 11 claim include but
21 are not limited to "every person who signed the registration
22 statement," "every person who was a director . . . of the issuer at
23 the time of the filing of the part of the registration statement
24 with respect to which his liability is asserted," "any person . . .
25 [who has] prepared or certified any report or valuation which is
26 used in connection with the registration statement," and "every
27 underwriter with respect to such security." Id.

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1 “The plaintiff in a § 11 claim must demonstrate (1) that the
2 registration statement contained an omission or misrepresentation,
3 and (2) that the omission or misrepresentation was material, that
4 is, it would have misled a reasonable investor about the nature of
5 his or her investment.” In re Stac Elecs. Sec. Litig., 89 F.3d
6 1399, 1403-04 (9th Cir. 1996) (citation and internal quotations
7 omitted). “No scienter is required for liability under § 11;
8 defendants will be liable for innocent or negligent material
9 misstatements or omissions.” Id. (citing Herman & MacLean v.
10 Huddleston, 459 U.S. 375, 382 (1983)).

11 Although a plaintiff need not plead loss causation in a § 11
12 claim, negative causation is an affirmative defense. See 15 U.S.C.
13 § 77k(e). A court may dismiss a complaint for lack of causation if
14 the affirmative defense is apparent from the face of the pleading.
15 See McCalden v. Cal. Library Ass’n, 955 F.2d 1214, 1219 (9th Cir.
16 1990) (quoting 5A C. Wright & A. Miller, Federal Practice and
17 Procedure § 1357 (2d ed. 1990)). In raising the affirmative
18 defense of negative causation, “the defendant has a heavy burden of
19 proving that the decline in stock price was caused by factors other
20 than the misstatement(s) in the registration statement.” In re
21 Flag Telecom Holdings, Ltd. Sec. Litig., 411 F. Supp. 2d 377, 383
22 (S.D.N.Y. 2006) (internal quotation marks omitted).

23 1. Section 11 and Control Person Liability Claims
24 Related to Series A Stock

25 The Underwriter Defendants and the Director Defendants
26 challenge the Section 11 and control person liability claims
27 related to the Series A preferred stock. New Century sold its
28 Series A preferred stock in June 2005, for approximately \$109

1 million. (Compl. ¶ 236.) The Underwriter Defendants and Director
2 Defendants argue that the Complaint (1) fails to sufficiently
3 allege material misstatements or omissions and (2) discloses on its
4 face the affirmative defense of negative causation.

5 a. Material Misstatements or Omissions

6 The Court's discussion of Plaintiffs' allegations of false and
7 misleading statements, supra Part II.E.1, is fully applicable to
8 the Section 11 claims. The Court determined that the Complaint
9 adequately alleges false and misleading statements with respect to
10 financial accounting, internal controls, and loan quality and
11 underwriting. The Court also determined that exceptions from
12 liability for "forward-looking statements" and "mere puffery"
13 cannot be found to conclusively apply based on the particular
14 circumstances alleged in the pleadings. The Complaint alleges
15 Section 11 claims in connection with the Series A stock against the
16 Officer Defendants, Director Defendants, and Underwriter
17 Defendants. These are appropriate defendants under 15 U.S.C. §
18 77k(a). The false and misleading statements for the Section 11
19 claim are largely the same as those alleged in Plaintiffs' Section
20 10(b) claims. The Court therefore finds that the Complaint
21 supports reasonable inferences of material false and misleading
22 statements.

23 b. Loss Causation

24 The Underwriter Defendants and the Director Defendants argue
25 that the alleged misstatements regarding the Series A stock did not
26 cause Plaintiffs to suffer a loss, and thus the Court should
27 dismiss the Section 11 claim with respect to Series A stock.
28 Specifically, the Underwriter Defendants and Director Defendants

1 emphasize that the disclosures between February 7, 2007 and March
2 13, 2007 "have nothing to do with the alleged misstatements in the
3 Series A Registration Statement." (Underwriter Defs.' Mot. at 30.)
4 The Court addressed this argument in connection with the claims
5 against KPMG, and incorporates that analysis here. Notwithstanding
6 any factual arguments regarding Plaintiffs inability to prove loss
7 causation, Plaintiffs have sufficiently alleged loss causation to
8 survive the pleading stage. The Section 11 claims regarding the
9 Series A stock, and the derivative Section 15 claims against the
10 Officer Defendants, may stand.

11 2. Section 11 and Control Person Liability Claims
12 Related to Series B Stock

13 Additionally, the Underwriter Defendants and the Director
14 Defendants challenge the allegations as to the Series B stock
15 offering, issued in August 2006. Defendants' arguments focus on
16 false and misleading statements rather than loss causation. The
17 Court incorporates its earlier analysis of false and misleading
18 statements, supra Part II.E.1. For the same reasons stated,
19 Plaintiffs may proceed with their Section 11 claims regarding the
20 Series B stock, and the derivative Section 15 claims against the
21 Officer Defendants.

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1 **III. CONCLUSION**

2 For the foregoing reasons, the Court substantially DENIES
3 Defendants' motions to dismiss and DENIES Defendant KPMG's motion
4 to strike. The Court dismisses allegations of false and misleading
5 statements that rely on the group pleading doctrine.

6 IT IS SO ORDERED.

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8 Dated: December 3, 2008



DEAN D. PREGERSON
United States District Judge

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