

In re Countrywide Financial Corporation Derivative Shareholder Litigation

COURT: United States District Court for the Central District of California
CASE NUMBER: 07-cv-06923
CLASS PERIOD: 2004 - 2008

Shareholder derivative action filed on behalf of Countrywide by Arkansas Teacher Retirement System ("ATRS"), Fire & Police Pension Association of Colorado ("FPPAC"), Louisiana Municipal Police Employees Retirement System ("LAMPERS"), Central Laborers Pension Fund, and the Mississippi Public Employees Retirement System ("MPERS") (collectively, "Plaintiffs") brought for the benefit of Countrywide Financial Corporation ("Countrywide" or the "Company"), against certain of the Company's senior officers and the members of its board of directors (the "Board").

This action alleges misconduct by the defendants and disregard for their fiduciary duties, including lack of good faith and lack of oversight of Countrywide's lending practices, financial reporting, and internal controls, as well as the sale by certain of the Company's officers and directors of over \$848 million of Countrywide stock at inflated prices while in possession of material inside information, between 2004 and 2008 (the "Relevant Period").

The case seeks to hold Countrywide's CEO, Angelo Mozilo, and its other officers and directors accountable for the severe harm caused to Countrywide and its shareholders. As the Complaint alleges, these individuals, entrusted with the responsibility of serving the best interests of shareholders, had the greatest and deepest insight into the impending collapse of the subprime mortgage market. While they continued to publicly tout the safety and security of the company's mortgage lending practices and strategy, they liquidated their personal holdings as fast as possible. Indeed, Mozilo and the board caused the Company to commence a \$2.5 billion stock repurchase plan in late 2006, sending the message to investors that the board believed the stock to be undervalued. At this same time, however, insiders were selling significant portions of their stock into the repurchase plan.

By Order dated May 14, 2008, the federal district court substantially denied Defendants' motions to dismiss the derivative claims, sustaining the claims under heightened pleading standards. In a 54-page opinion, the federal district court concluded that the "allegations create a cogent and compelling inference that the [Countrywide officers and directors] misled the public with regard to the rigor of Countrywide's loan origination process, the quality of its loans, and the Company's financial situation – even as they realized that Countrywide had virtually abandoned its own loan underwriting practices." In addition, the court found that the fourteen confidential witnesses "paint a compelling portrait of a dramatic loosening of underwriting standards in Countrywide branch offices across the United States," representing "a rampant disregard for underwriting standards." The court thus concluded that the confidential witnesses support a "strong inference of a Company-wide culture that, at every level, emphasized increased loan origination volume in derogation of underwriting standards."

The court rejected Defendants' arguments that the widespread malfeasance at Countrywide went on without the directors' knowledge: "[T]he idea that a Company-wide culture that encouraged unchecked deviations from underwriting standards in a way which would fatally affect the Company's continued financial performance went unnoticed by a Board of Directors simply does not square with the specific and comprehensive monitoring duties assigned to the members of the Board." The court also rejected defendants' attempt to blame Countrywide's

downfall on a general “economic downturn,” explaining that, “[i]ndependent of any turmoil in the capital markets, the widespread violations of underwriting standards, as alleged, would significantly raise the risk of loan default.

When combined with what Plaintiffs allege are misrepresentations concerning the quality of Countrywide’s loans, these underwriting issues would ultimately undermine confidence in the secondary market for Countrywide products.” The court also found that the massive insider sales allegations were consistent with the strong inference of scienter. The court queried: “How could the Board members approve a repurchase of \$2.4 billion worth of stock, and nearly contemporaneously liquidate \$148 million of their personal holdings just months before the stock dropped some 80-90%?” The court likewise sustained the Complaint’s corporate waste allegations with respect to the stock repurchase program, finding that the claim is “not subject to protection by the business judgment rule because, as the Court observed, it may have served to delay the eventual impairment caused by unsound business practices.” Finally, the court found that “the Complaint pleads evidence of a ‘sustained or systematic failure of the board to exercise oversight’ . . . so as to create a substantial likelihood of liability for at least the members of those [Audit, Finance, and Ethics] Committees.” The court concluded as follows:

“It defies reason, given the entirety of the allegations, that these Committee members could be blind to widespread deviations from the underwriting policies and standards being committed by employees at all levels. At the same time, it does not appear that the Committees took corrective action. . . . [The Complaint] provides enough of a factual basis for this Court to determine that a majority of the directors are “interested” for demand purposes”

Following the July 1, 2008 closing of Countrywide’s merger with Bank of America, the federal district court granted Defendants judgment on the pleadings on the grounds that Plaintiffs lost standing to pursue the derivative claims as a result of the merger. Plaintiffs appealed to the Ninth Circuit Court of Appeals, arguing that the Delaware Supreme Court’s decision in Plaintiff’s separate appeal of a settlement in a related case challenging the merger, *Arkansas Teacher Retirement System v. Caiafa*, clarified Delaware law to allow standing by a derivative plaintiff where the merger was necessitated by, and is inseparable from, the fraud that is the subject of the derivative claims. Oral argument on the Ninth Circuit appeal was held on November 8, 2012. Following oral argument, the Ninth Circuit certified the following question to the Delaware Supreme Court, which the Delaware Supreme Court then accepted:

Whether, under the “fraud exception” to Delaware’s continuous ownership rule, shareholder plaintiffs may maintain a derivative suit after a merger that divests them of their ownership interest in the corporation on whose behalf they sue by alleging that the merger at issue was necessitated by, and is inseparable from, the alleged fraud that is the subject of their derivative claims.

Plaintiffs filed their opening brief with the Delaware Supreme Court on February 13, 2013. Full briefing is expected to be completed in April 2013.