The Honorable Marsha J. Pechman

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON

THE FEDERAL DEPOSIT INSURANCE CORPORATION, as RECEIVER of WASHINGTON MUTUAL BANK, Plaintiff, v. KERRY K. KILLINGER, STEPHEN J. ROTELLA, DAVID C. SCHNEIDER, LINDA C. KILLINGER, and ESTHER T. ROTELLA, Defendants.	Case No.: 2:11-cv-00459-MJP PLAINTIFF FDIC'S CONSOLIDATED RESPONSE TO MOTIONS TO DISMISS OF DEFENDANTS KERRY AND LINDA KILLINGER, STEPHEN ROTELLA, AND DAVID SCHNEIDER ORAL ARGUMENT REQUESTED **Noted on Motion Calendar: September 15, 2011**

Plaintiff Federal Deposit Insurance Corporation, as Receiver of Washington Mutual Bank ("FDIC"), by and through its undersigned attorneys, hereby submits this consolidated response to the Motions to Dismiss of Defendants Kerry and Linda Killinger ("Killinger"), Stephen Rotella ("Rotella") and David Schneider ("Schneider") (collectively, "Defendants").[1] All but Linda Killinger are former top executives of Washington Mutual Bank ("WaMu" or "the Bank"). For the reasons stated below, the Defendants' motions should be denied.

[1] Unless otherwise noted, the term "Defendants" excludes Linda Killinger. She has joined in Kerry Killinger's motion to dismiss solely for purposes of arguing that the fraudulent conveyance and asset freeze claims against her should be dismissed because the negligence and breach of fiduciary duty claims against her husband have no merit. This aspect of the motion should be denied because the FDIC has pled valid causes of action against Kerry Killinger. Defendant Esther Rotella's motion to dismiss also is not addressed in this response because the FDIC has requested an extension to respond to her motion after it receives answers to its jurisdictional discovery requests.

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I. INTRODUCTION

The Office of Thrift Supervision ("OTS") closed WaMu and appointed the FDIC as receiver on September 25, 2008, the 119th anniversary of the Bank's founding. The allegations contained in the FDIC's 60-page Complaint are the product of a comprehensive 2½ year investigation into the largest bank failure in U.S. history. During the relevant times, WaMu employed as many as 60,000 employees and maintained over 2,000 branch offices, approximately 472 lending centers and 325 administrative offices. The FDIC's investigation required data management of over two terabytes of information and involved dozens of interviews and administrative depositions of former bank employees and witnesses. The investigation required the analysis of hundreds of thousands of pages of documents, including testimony taken from the three principal defendants — Kerry Killinger, Stephen Rotella and David Schneider — given before the U.S. Senate.

In response to the FDIC's Complaint, Defendants Rotella and Schneider assert that the allegations against them are a "publicity stunt," and seek to divert attention from their own alleged mismanagement and greed by casting blame on the FDIC, the OTS, and outside appraisal companies that the FDIC has sued in other lawsuits — in short, they cast blame on everyone but themselves. This well-worn strategy should be rejected. The FDIC's factual allegations, which must be taken as true under Rule 12(b)(6), demonstrate that under the Defendants' leadership and direction, WaMu made and acquired an enormous number of high-risk loans with virtually no regard for prudent lending standards or risk management. (*See, e.g.*, FDIC's Complaint ("Compl.") ¶¶ 1-8, 136.) Their conduct caused the Bank to incur billions of dollars in losses. (*Id.* at ¶¶ 11, 175-180.) Hyper-focused on Wall Street's approval and on short-term profits from a high volume of high-margin products — which in turn fueled their lavish compensation — the Defendants turned a blind eye to the huge loan losses that inevitably would follow from their aggressive pursuit of a "Higher Risk Lending Strategy" during an unsustainable housing bubble. (*See, e.g.*, *id.* at ¶¶ 7, 10-11, 40-41, 53, 64, 142, 161.) WaMu's losses were neither the product of careful executive decision-making, nor defensible business judgments that happened to turn out badly. Rather, the Complaint alleges that WaMu's losses resulted from the Defendants'

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reckless management of a Higher Risk Lending Strategy using few controls, deliberately muting the voice of risk managers, ignoring weak infrastructure, and failing to meaningfully assess the extreme risks to which their strategy was exposing the Bank. (*See*, *e.g.*, *id.* at ¶¶ 6-9, 88-106, 175-176.) The Complaint further alleges that the Defendants failed to devise a coherent lending strategy based on analysis of reliable data and adherence to banking fundamentals — something any reasonable bank officer or director would do. (*See*, *e.g.*, *id.* at ¶¶ 6, 9, 88-89, 99-106, 176, 185a.-o.) Instead, the Defendants threw caution to the wind and embarked on a strategy to make as many loans as possible, regardless of borrowers' ability to repay, in order to increase the Bank's short-term profits and their own compensation. (*See*, *e.g.*, *id.* at ¶¶ 1-5, 10, 22-25, 42-43, 53-56, 62-63, 65-67, 71, 76-78.)

Casting aside the Defendants' rhetoric, the primary legal contention in their motions to dismiss is that their conduct is protected by the business judgment rule. That argument fails for two reasons. First, the business judgment rule is a *fact-bound affirmative defense* that does not provide grounds for dismissing a complaint under the federal notice pleading standard of Rule 12(b)(6). The Defendants' arguments on this issue fail because they are premised on inapplicable cases decided under different legal standards, *e.g.*, summary judgment and post-trial proceedings, and to cases interpreting Delaware procedural rules that contain heightened pleading standards. Second, under Washington law, the business judgment rule does not apply when officers and directors fail to act with *ordinary due care* in their decision-making process, as is the case here. The FDIC's Complaint alleges that the Defendants failed to use due care in their decision-making in at least three respects:

- The Defendants knew that WaMu had a woefully inadequate risk infrastructure that was incapable of measuring, monitoring or controlling its risky lending. In other words, the Defendants gambled billions of dollars of WaMu's money on high risk loans to high-risk borrowers in high-risk areas without having the necessary tools to measure or predict the odds of ever recovering that money. (*See*, *e.g.*, Compl. ¶¶ 5, 6, 9, 88, 99-106, 134-135, 176, 185.l-n.)

- The Defendants marginalized risk management by subordinating it to the profit-oriented business lines, and demeaning and ignoring risk managers'

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pleas to pull back on the Bank's High Risk Lending Strategy. (*See, e.g.*, Compl. ¶¶ 8-10, 27-39, 44-46, 51-52, 54, 90-98, 122, 126, 131, 185.b., d.-k., o.)

- The Defendants based their Higher Risk Lending Strategy on ever-increasing home prices, but developed no exit plan for stemming the tide of loan losses when the housing bubble inevitably burst. (*See, e.g.*, Compl. ¶¶ 2, 7, 11, 40-41, 53, 64, 142, 161, 185.c.)

The business judgment rule does not protect such a narrow-minded and ill-informed approach to risk-taking at a federally insured banking institution. It is not a reasonable business judgment to push a bank to take huge and unprecedented lending risks while marginalizing input from risk management, not addressing the lack of risk infrastructure to measure and control those risks, and not acknowledging the reality that the housing bubble would burst and lead to potentially disastrous loan losses without a plan to mitigate those losses. Because the Defendants did not exercise due care in reaching the decisions at issue, they cannot now use the business judgment rule to shield those decisions from judicial scrutiny.

The Defendants make other arguments to support their motions to dismiss, but these also lack merit. Rotella and Schneider assert that the FDIC cannot prove proximate cause because it has alleged in another case that certain outside appraisal companies caused WaMu to originate risky loans that led to losses. This assertion is disingenuous because it ignores well settled law that (i) there may be multiple causes of the same loss, (ii) a party is not restricted from suing multiple defendants at the pleading stage, and (iii) the FDIC is not legally bound by its allegations in other cases. Rotella and Schneider's argument further ignores the fact that the appraiser cases involve loans that are a mere subset of the thousands of loans at issue in this case. Defendants also argue that FDIC's breach of fiduciary duty claim should be dismissed because it duplicates its negligence claims. However, breach of fiduciary duty and negligence claims are different causes of action and there is no good reason to prevent the FDIC from pleading these claims in the alternative at this early stage of the case. Lastly, the FDIC's fraudulent transfer claims should survive the Defendants' motions to dismiss because the FDIC has sufficiently pled that Killinger, Rotella and their wives improperly transferred their assets in an attempt to place

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them beyond the reach of creditors. For all these reasons, Defendants' motions to dismiss should be denied.[2]

II. ARGUMENT

A. The FDIC's Complaint Need Only Allege a Plausible Claim for Relief.

"To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'" *In re Washington Mutual, Inc. Secs., Derivative & ERISA Litig*., 694 F. Supp. 2d 1192, 1205 (W.D. Wash. 2009) (Pechman, J.) (citing *Ashcroft v. Iqbal*, ___ U.S. ___, 129 S. Ct. 1937, 1949 (2009) (citing *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007)). A claim is plausible "when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the conduct alleged." *Labadie v. U.S.*, No. C09-1276 MJP, 2011 WL 1376235, at *2 (W.D. Wash. Apr. 12, 2011) (Pechman, J.) (citing *Iqbal*, 129 S. Ct. at 1949 (citing *Twombly*, 550 U.S. at 545)). "The plausibility standard is not akin to a 'probability requirement,' but it asks for more than a sheer possibility that a defendant has acted unlawfully." *Fayer v. Vaughn*, No. 10-15520, ___ F.3d ___, 2011 WL 1663595, at *2 (9th Cir. May 4, 2011) (citing *Iqbal*, 129 S. Ct. at 1949). Thus, a claim is "plausible" so long as the factual allegations "raise a right to relief above the speculative level." *Twombly*, 550 U.S. at 555. This is an easy-to-clear hurdle because, when ruling on a Rule 12(b)(6) motion, the Court must "accept factual allegations in the complaint as

[2] Much of Rotella and Schneider's motion to dismiss comprises irrelevant accusations and vitriol regarding what they believe was the FDIC's alleged role in the financial crisis and what they purport the motivation was behind the decision of the Office of Thrift Supervision ("OTS") to close WaMu. Rotella and Schneider also remark in detail about OTS's historical ratings of the Bank. (Rotella & Schneider's Mot. at 1-7.) None of these issues appear anywhere in the Complaint or in any documents referenced in it, and are not properly the subject of a Rule 12(b)(6) motion. *See N.M. State Inv. Council v. Ernst & Young LLP*, 641 F.3d 1089, 1094 (9th Cir. 2011) (review of Rule 12(b)(6) motion is "generally limited to the face of the complaint, materials incorporated into the complaint by reference, and matters of judicial notice"). Rotella and Schneider also rely heavily on carefully selected news articles and other public documents, which they claim support the truth of their propositions, notwithstanding their knowledge that the Court cannot take judicial notice of the truth of these documents. *See Von Saher v. Norton Simon Museum of Art at Pasadena*, 592 F.3d 954, 960 (9th Cir. 2010) ("Courts may take judicial notice of publications introduced to 'indicate what was in the public realm at the time, ***not whether the contents of those articles were in fact true***.'") (citation omitted, emphasis added). The FDIC respectfully requests that the Court reject these assertions and outside materials as irrelevant to the issues before the Court on Defendants' Rule 12(b)(6) motions.

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true and construe the pleadings in the light most favorable to the non-moving party." *Fayer*, 2011 WL 1663595, at *2 (citation omitted); *Labadie*, 2011 WL 1376235, at *2.

Significantly, the federal notice pleading standard continues to apply after *Twombly*. *See Iqbal*, 129 S. Ct. at 1949 ("[T]he pleading standard Rule 8 announces does not require 'detailed factual allegations'") (citing *Twombly*, 550 U.S. at 555); *Erickson v. Pardus*, 551 U.S. 89, 93 (2007) ("Federal Rule of Civil Procedure 8(a)(2) requires only 'a short and plain statement of the claim showing that the pleader is entitled to relief.' Specific facts are not necessary; the statement need only 'give the defendant fair notice of what the . . . claim is and the grounds upon which it rests.'") (citing *Twombly*, 550 U.S. at 555).

B. The Business Judgment Rule Does Not Protect the Defendants' Negligent and Uninformed Business Decisions.

1. Application of the Business Judgment Rule Generally Cannot Be Resolved on a Rule 12(b)(6) Motion in Federal Court.

Because application of the business judgment rule almost always depends on the resolution of disputed fact issues, federal courts routinely deny as premature Rule 12(b)(6) motions based on the business judgment rule. *See, e.g.*, *In re Reading Broadcasting, Inc.*, 390 B.R. 532, 556 (Bankr. E.D. Pa. 2008) ("There is no basis, considering only the allegations raised by the complaint, upon which I can now determine that the business judgment rule should or should not apply."); *Talib v. Skyway Comm. Holding Corp.*, No. 805CV282T17TBM, 2005 WL 1610707, at *6 (M.D. Fla. July 7, 2005) ("It is . . . premature for the business judgment rule to be applied at this stage of the case, as discovery has not commenced."). Indeed, in the two federal court decisions cited by Defendants involving a business judgment rule defense asserted under Rule 12(b)(6), the motion to dismiss was denied. *See Grassmueck v. Barnett*, No. C03-122P, 2003 WL 22128263, at *1, 4 (W.D. Wash. July 7, 2003); *Washington Bancorp. v. Said*, 812 F. Supp. 1256, 1269 (D.D.C. 1993).

In addition, federal courts have held that when the business judgment rule is not explicitly raised on the face of the plaintiff's complaint, it is inappropriate to resolve such an affirmative defense on a Rule 12(b)(6) motion. *See, e.g.*, *Batlan v. WT Consulting, Inc.*, No. 08-

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3196-elp, 2009 WL 936664, at *3 (Bankr. D. Or. Jan. 26, 2009) ("The business judgment rule is a defense. . . . Under the federal notice pleading standard, a plaintiff is not required to preemptively plead around defenses not alleged in his complaint.") (citations omitted); *Ad Hoc Comm. of Equity Holders of Tectonic Network, Inc.*, 554 F. Supp. 2d 538, 556-57 (D. Del. 2008) ("Generally speaking, [the court] will not rely on an affirmative defense such as the business judgment rule to trigger dismissal of a complaint under Rule 12(b)(6)"; the mere fact that the business judgment rule is "implicitly" raised by the allegations of the complaint does not require the plaintiff to plead around this defense) (citing *In re Tower Air, Inc.*, 416 F.3d 229, 238 (3d Cir. 2005)); *Shamrock Holdings v. Arenson*, 456 F. Supp. 2d 599, 609 (D. Del. 2006) (same); *Resolution Trust Corp. v. Bernard*, No. 94-CV-475, 1995 WL 17164886, at *12 (M.D.N.C. Aug. 8, 1995) ("the business judgment rule is a factually based affirmative defense that is inappropriate for consideration on a motion to dismiss"). Because the FDIC's Complaint does not explicitly raise the business judgment rule on its face, it is inappropriate to resolve this asserted defense on Defendants' motions to dismiss.[3]

Defendants also improperly rely on Delaware state court decisions, which, unlike the federal rules, require pleading of *specific facts* to survive a motion to dismiss. *See Tower Air*, 416 F.3d at 236 ("Delaware cases are legion requiring specific allegations of fact to support a plaintiff's demand for relief under Chancery Rule 8."); *Grobow v. Perot*, 539 A.2d 180, 187 n.6 (Del. 1988) ("neither inferences nor conclusions of fact unsupported by allegations of specific facts upon which the inferences or conclusions rest are accepted as true"); *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 194 (Del. Ch. 2006) ("our law requires that a

[3] Many of Defendants' cited cases involved decisions on summary judgment or at a bench trial, *not* on a motion to dismiss directed at the pleadings. *See, e.g.*, *Scott v. Trans-System, Inc.*, 64 P.3d 1, 4 (Wash. 2003) (en banc) (bench trial); *FDIC v. Castetter*, 184 F.3d 1040, 1043 (9th Cir. 1999) (summary judgment); *Riss v. Angel*, 934 P.2d 669, 675, 680-81 (Wash. 1997) (en banc) (bench trial); *Wash. Bancorp. v. Said*, 812 F. Supp. 1256, 1269 (D.D.C. 1993) (summary judgment); *Citron v. Fairchild Camera and Instrument Corp.*, 569 A.2d 53, 55 (Del. 1989) (bench trial); *Para-Medical Leasing, Inc. v. Hangen*, 739 P.2d 717, 718, 720 (Wash. Ct. App. 1987) (bench trial); *Joy v. North*, 692 F.2d 880, 884 (2d Cir. 1982) (summary judgment); *Schwarzmann v. Ass'n of Apt. Owners of Bridgehaven*, 655 P.2d 1177, 1179, 1181 (Wash. Ct. App. 1982) (partial summary judgment); *Nursing Home Bldg. Corp. v. DeHart*, 535 P.2d 137, 140, 144 (Wash Ct. App. 1975) (bench trial).

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plaintiff plead facts supporting an inference that directors committed a cognizable breach of duty.”). These Delaware cases do not comport with the *federal* notice pleading standard even after *Twombly*. *See Erickson*, 551 U.S. at 93 (“Specific facts are not necessary” under Fed. R. Civ. P. 8(a)(2)) (citing *Twombly*, 550 U.S. at 555)); *Tower Air*, 416 F.3d at 236-37 (the district court erred when it determined that Delaware pleading standard was “interchangeable with federal notice pleading cases” and “erroneously preempted discovery on certain claims by imposing a heightened pleading standard not required by Federal Rule of Civil Procedure 8”).

More troubling is the Defendants’ improper reliance on a number of cases involving the heightened pleading standard for shareholder derivative claims under Delaware Chancery Rule 23.1 and similar rules. *See, e.g., In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 112 (Del. Ch. 2009); *Shoen v. SAC Holding Corp.*, 137 P.3d 1171, 1178-80 (Nev. 2006) (Nevada Rule of Civil Procedure 23.1); *Brehm v. Eisner*, 746 A.2d 244, 248, 254-55 (Del. 2000); *Gagliardi v. Trifoods Int’l, Inc.*, 683 A.2d 1049, 1054-55 (Del. Ch. 1996). Under Delaware Chancery Rule 23.1 and its federal and state counterparts, a shareholder derivative plaintiff must establish at the pleading stage that a demand on the board of directors has been excused or would be futile. Del. Ch. Rule 23.1(a); Fed. R. Civ. P. 23.1(b)(3). Courts have interpreted these rules as imposing a heavy burden on the shareholder derivative plaintiff to allege with particularity facts creating a “reasonable doubt that the directors’ action was entitled to the protection of the business judgment rule.” *See, e.g., In re Abbott Labs Derivative S’holders Litig.*, 325 F.3d 795, 806-07 (7th Cir. 2003) (citing *Aronson v. Lewis*, 473 A.2d 805, 808 (Del. 1984)); *Brehm*, 746 A.2d at 254-55. Here, however, the FDIC’s lawsuit is brought in its capacity as Receiver for WaMu, *not* as a shareholder derivative claim. Therefore, the FDIC’s Complaint is *not* subject to the heightened pleading requirements asserted by the Defendants.

In sum, Defendants’ reliance on cases decided on summary judgment or post-trial motions and those involving Delaware’s heightened fact pleading and Rule 23.1 pleading standards are inapposite. None of cases cited by the Defendants regarding the business judgment rule resulted in a plaintiff’s claim being dismissed under Federal Rule 12(b)(6). The business

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judgment rule defense cannot be properly decided on Defendants' Rule 12(b)(6) motion. For this reason alone, the Defendants' motions should be denied.

2. Under Washington Law, Director and Officer Liability Is Judged by an Ordinary Negligence Standard.

The FDIC's lawsuit is brought pursuant to its authority under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") codified at 12 U.S.C. § 1821 *et seq*. FIRREA provides that a "director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action . . . for gross negligence . . . . Nothing in this paragraph shall impair or affect any right of the [FDIC] under other applicable law." 12 U.S.C. § 1821(k). The Supreme Court in *Atherton v. FDIC*, 519 U.S. 213, 227 (1997), clarified that "the statute's 'gross negligence' standard provides only a floor . . . It does not stand in the way of a stricter standard that the laws of some States provide." In other words, where States treat directors and officers more strictly by holding them liable for simple negligence, as opposed to gross negligence, the state standard will apply. *See id.* at 216 ("We conclude that state law sets the standard of conduct as long as the state standard (such as simple negligence) is stricter than that of the federal statute.").

Washington law employs a simple negligence standard for the conduct of officers and directors, which should be applied in this case.[4] Washington statute RCW 23B.08.420(1) sets forth the applicable standard of conduct for the Defendants:

> (1) An officer with discretionary authority shall discharge the officer's duties under that authority:
>
> (a) In good faith;
>
> (b) ***With the care an ordinarily prudent person in a like position would exercise under similar circumstances***; and
>
> (c) In a manner the officer reasonably believes to be in the best interests of the corporation.

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[4] The parties appear to agree that Washington state law governs the application of the business judgment rule in this case. *See, e.g.*, Killingers' Mot. to Dismiss at 5-7 (citing Washington cases on the business judgment rule); Rotella and Schneider's Mot. to Dismiss at 11-12 (same).

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(emphasis added). RCW 23B.08.300(1) sets forth the identical standard for directors. The Washington Supreme Court has held that these statutes are a "codification of the 'business judgment rule'" in Washington. *See Hines v. Data Line Sys., Inc.*, 787 P.2d 8, 18 (Wash. 1990) (en banc) (referring to RCW 23A.08.343, the predecessor to 23B.08.300 and 23B.08.420); *see also Riss v. Angel*, 934 P.2d 669, 681 n.5 (Wash. 1997) (en banc) ("the business judgment rule was codified at former RCW 23A.08.343") (citing *Schwarzmann v. Ass'n of Apt. Owners of Bridgehaven*, 655 P.2d 1177, 1180 n.1 (Wash. Ct. App. 1982)). Significantly, the Washington Supreme Court has held that the "standards for directors and officers of corporations are presently set out in RCW 23B.08, and ***include an ordinary care standard***." *Riss*, 934 P.2d at 681 n.5 (emphasis added); *see also In re Spokane Concrete Prods., Inc.*, 892 P.2d 98, 104 (Wash. 1995) ("directors may take risks in the interest of their corporation so long as they comply with RCW 23B.08.300(1), which requires them to act in good faith, ***with the care an ordinarily prudent person in a like position would exercise under similar circumstances***, and in a manner they reasonably believe to be in the best interests of the corporation") (emphasis added).

The test for applying the business judgment rule in Washington thus expressly incorporates the statutory ordinary care standard: "a court will not substitute its judgment for that of corporate directors '[u]nless there is evidence of fraud, dishonesty or **incompetence (i.e., *failure to exercise proper care, skill and diligence*)**.'" *Riss*, 934 P.2d at 681 (citing *In re Spokane Concrete*, 892 P.2d at 104) (bold emphasis added). The Washington Supreme Court has emphasized that "[r]easonable care is required" under the business judgment rule, and that "good faith is insufficient because a director must also act with such care as a reasonably prudent person in a like position would use under similar circumstances." *Id.* (citing *Shinn v. Thrust IV, Inc.*, 786 P.2d 285 (Wash. Ct. App. 1990)).[5] Accordingly, the relevant standard of conduct to be

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[5] In *Scott v. Trans-System, Inc.*, 64 P.3d 1, 5 (Wash. 2003) (en banc), the Washington Supreme Court noted that the business judgment rule applies when "there is a reasonable basis to indicate that the transaction was made in good faith." However, this remark was made in the context of a claim for judicial dissolution under RCW 23B.14.300 due to oppressive conduct. In that context, the only pertinent inquiry was whether the majority shareholder's conduct was in good faith, not whether it was

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applied in resolving the business judgment rule defense in this case is ordinary negligence as opposed to gross negligence. *Atherton*, 519 U.S. at 216, 227.

Federal courts in this district also have held that Washington's business judgment rule requires a showing of "due care" as a prerequisite. In *Seafirst Corp. v. Jenkins*, 644 F. Supp. 1152, 1158 (W.D. Wash. 1986), a bank sued its officers and directors for "negligent mismanagement" that allegedly had caused the bank to "incur large loan losses." After surveying Washington law, the district court determined that "good faith alone is not sufficient to satisfy the business judgment rule." *Id.* at 1159. Rather, "the statutory standard of ordinary care" under RCW 23A.08.343 applied. *Id.* at 1158-59. The court therefore denied summary judgment to the defendants as to the application of the business judgment rule, finding that the trier of fact would have to decide any disputed issues regarding their exercise of ordinary care. *Id.* at 1159. This Court too has cited *Seafirst* for the proposition that, "in Washington, even a showing of good faith may not be enough to remain shielded by the business judgment rule." *Grassmueck*, 2003 WL 22128263, at *3 (citing *Seafirst*, 644 F. Supp. at 1158).

Defendants admit, as they must, that Washington has incorporated an ordinary negligence standard into its business judgment rule, and that good faith alone does not suffice to invoke that defense. (*See* Killingers' Mot. at 6 (citing RCW 23B.08.300, RCW 23B.08.420, and the "incompetence" language in *Riss*); Rotella and Schneider's Mot. at 12 (citing the "incompetence" standard under *Riss* and *In re Spokane*).) But Defendants try to narrowly limit this ordinary care standard to mean "a failure 'to act in an informed manner.'" (Killingers' Mot. at 6; Rotella & Schneider's Mot. at 12.) Defendants fail to cite a single Washington case that supports this proposition, and rely instead on cases from Delaware and Nevada. This narrow interpretation of Washington's ordinary care standard is incorrect. Neither Delaware nor Nevada has a statute similar to the Washington statute that requires directors and officers to act "[w]ith the care an ordinarily prudent person in a like position would exercise under similar

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"reasonable." Thus, there is no indication that the Washington Supreme Court in *Scott* sought to modify the "reasonable care" standard for applying the business judgment rule under RCW 23B.08.300 and 23B.08.420. *Riss*, 934 P.2d at 681.

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circumstances." RCW 23B.08.300(1)(b); RCW 23B.08.420(1)(b). Instead, Nevada's statute speaks of acting "on an informed basis." *See* Nev. Rev. Stat. § 78.138(3) ("Directors and officers, in deciding upon matters of business, are presumed to act in good faith, *on an informed basis* and with a view to the interests of the corporation.") (emphasis added). And the Delaware statute speaks of a director's "reasonable" reliance on experts who are selected with "reasonable care." Del. Code § 141(e). Thus, case law in Delaware and Nevada is not analogous because it does not analyze the broad statutory "due care" language that exists in Washington.

Courts in other jurisdictions have analyzed the interaction between a director's or officer's standard of due care and the business judgment rule. For instance, in *FDIC v. Stahl*, 89 F.3d 1510, 1516 (11th Cir. 1996), the Eleventh Circuit interpreted a Florida statute that was virtually identical to the Washington statute, and provided that directors were to perform their duties "in good faith . . . in a manner . . . reasonably believe[d] to be in the best interests of the corporation, and *with such care as an ordinarily prudent person in a like position would use under similar circumstances*." (citing Fla. Stat. § 607.111(4) (1987)) (currently codified at Fla. Stat. § 607.0830) (original emphasis). The Eleventh Circuit found that this statute "clearly established an ordinary negligence standard of director liability." *Id.* The court further held that in order for "directors to be entitled to the cloak of protection of the BJR [business judgment rule] on the merits of their judgments . . . they still must have exercised due care in making them." *Id.* at 1517. The court explained:

> The question is frequently asked, how does the operation of the so-called "business judgment rule" tie in with the concept of negligence? There is no conflict between the two. When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment — reasonable diligence — has in fact been exercised. A d[i]rector cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment.

Id. (quoting *Casey v. Woodruff*, 49 N.Y.S.2d 625, 643 (N.Y. Sup. Ct. 1944)). The Eleventh Circuit therefore concluded that the business judgment rule "merely protects directors who exercised reasonable diligence in the first instance from liability on the merits of their business judgment." *Id.* at 1518. The court in *Stahl* expressly distinguished the Delaware and District of

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Columbia cases relied on by the defendants in that case because "neither of these states had a general statute setting forth an ordinary care standard." *Id.* at 1518 n.14 (rejecting application of *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) and *Wash. Bancorp. v. Said*, 812 F. Supp. 1256, 1269 (D.D.C. 1993)).

Similarly, California's director liability statute includes a requirement that a director act "with such care, *including* reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." Cal. Corp. Code § 309(a) (emphasis added). While the statute lists "reasonable inquiry" as one form of due care, it does not narrowly restrict the duty in the manner urged by Defendants here. California courts have interpreted this statute as codifying the business judgment rule "with the concept of a director's obligation of reasonable diligence in the performance of his or her duties." *Gaillard v. Natomas Co.*, 256 Cal. Rptr. 702, 710 (Cal. App. Ct. 1989); *see also McDonnell v. Am. Leduc Petroleums, Ltd.*, 491 F.2d 380, 384 (2d Cir. 1974) ("The business judgment rule protects only reasonable acts of a director or officer.") (applying California law and citing *Burt v. Irvine Co.*, 47 Cal. Rptr. 392, 407-09 (Cal. Dist. Ct. App. 1965)).[6]

Washington's "incompetence" standard is defined quite broadly to mean a "failure to exercise proper care, skill, and diligence." *Riss*, 934 P.2d at 681 (citing *In re Spokane Concrete*, 892 P.2d at 104). To be sure, this phrase *includes* a failure to act in an informed manner, such as the failure to conduct an adequate investigation, but it is not limited to such conduct. *See id.* ("it is clear that the [business judgment] rule if applied here would not exonerate the homeowners for their unreasonable decision to reject Plaintiffs' proposal. ***At the least***, their failure to adequately

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[6] Federal and state courts in other states similarly have found that reasonable care is a prerequisite to application of the business judgment rule. *See, e.g.*, *Davis v. Dyson*, 900 N.E.2d 698, 714 (Ill. App. Ct. 2008) ("If directors fail to exercise due care, then they may not use the business judgment rule as a shield for their conduct."); *FDIC v. Bierman*, 2 F.3d 1424, 1434 (7th Cir. 1993) ("Despite the defendant directors' arguments that they were shielded by the business judgment rule and that the district court did no more than substitute its judgment for theirs, the court clearly, and correctly, determined that, at the time the loans were made, a reasonably prudent director would not have approved such transactions."); *Bernard*, 1995 WL 17164886, at *12 ("the business judgment rule and liability for ordinary negligence are not mutually exclusive. North Carolina courts have noted that, to some extent, application of the business judgment rule presupposes the exercise of reasonable care in reaching the business decision at issue.") (citations omitted).

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investigate would remove them from the rule's insulating effect.") (emphasis added); *Davis v. Dyson*, 900 N.E.2d 698, 714 (Ill. App. Ct. 2008) ("***One component of due care*** is that directors must inform themselves of material facts necessary for them to properly exercise their business judgment.") (emphasis added). Washington's ordinary negligence standard requires that the Court to take into account the *entire process* by which Defendants reached their decisions to determine whether those decisions were made with the "proper care, skill, and diligence" required to invoke the business judgment rule's protection for the merits of their decisions. *Riss*, 934 P.2d at 681 (citing *In re Spokane*, 892 P.2d at 104); *see also Shinn*, 786 P.2d at 290-91 (refusing to apply business judgment rule where the defendant's conduct "violated the due care standard requisite to application of the rule," including "failure to advance the project in a 'timely and workmanlike manner' despite knowledge of the risk to the project if critical phases were not complete prior to the onset of adverse weather in the fall and winter").

3. The FDIC's Complaint Alleges that the Defendants Lacked Due Care in Their Decision-Making, Which Prevents Them From Shielding Their Decisions Under the Business Judgment Rule.

The facts alleged in the Complaint, which must be accepted as true on a Rule 12(b)(6) motion, clearly support a plausible inference that the Defendants failed to exercise "proper care, skill and diligence" in their decision-making, and therefore, are not protected by the business judgment rule. *Riss*, 934 P.2d at 681 (citing *In re Spokane*, 892 P.2d at 104). Specifically, the Complaint alleges that Defendants failed to exercise due care by, among other things: (1) making decisions without an adequate risk infrastructure in place to quantify and predict future loan losses; (2) marginalizing risk managers and refusing to take their advice into account in their decision-making; and (3) moving forward with a high-risk lending strategy that was doomed to lead to future loan losses but with no exit plan to avoid or mitigate those losses. For these reasons, the Defendants' motions to dismiss should be denied.[7]

[7] The Defendants argue incorrectly that "due care" is not the applicable standard under Washington law. But even if the Defendants were correct that the business judgment rule requires only good faith, "informed" decisions, the FDIC's Complaint plainly meets this standard as well and therefore should not be dismissed.

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a. The Defendants Made Their Decisions Knowing That the Bank Lacked an Adequate Risk Infrastructure to Measure, Monitor and Control Those Risks.

The FDIC's Complaint is replete with allegations that the Defendants did not act with due care when they pushed WaMu to make large volumes of high-risk loans knowing that the Bank lacked the infrastructure to properly measure and manage those risks or predict future loan losses. In one of his Strategic Direction Memoranda, Defendant Killinger spoke of "intelligent credit-risk taking" and the need to have "good underwriting and monitoring processes and controls." (*See* Complaint ¶ 53.) However, the Complaint alleges that the Defendants did exactly the opposite: they caused WaMu to engage in uninformed and unprecedented risk-taking on a scale that jeopardized the soundness of the Bank. This type of gross mismanagement is not within the protection of the business judgment rule, even as broadly construed by the Defendants. *Riss*, 934 P.2d at 681; *In re Spokane*, 892 P.2d at 104; RCW 23B.08.300(1); RCW 23B.08.420(1).

For instance, the Complaint specifically alleges that the Defendants caused WaMu to take risks without fully informing themselves of the extent of the risks:

> Defendants took this gamble knowing that they did not even understand the odds against them. Defendants knew that the Bank had a woefully inadequate infrastructure — including technology, controls, and data quality — to support the high volume of risky loans that were contained in WaMu's HFI portfolio. The Bank could not adequately track and analyze its loans, measure or price for its risks, or timely adjust to changes in the market.

(Compl. ¶ 6.) Similarly, the Complaint alleges that, "[a]n outside consultant firm reported to the Bank in or about April 2007 that WaMu had numerous deficiencies in its ability to analyze loan data effectively so as to manage the risks within its HFI home loans portfolio." (*Id.* at ¶ 102.) The Complaint also points out that Defendant Rotella acknowledged in testimony before a Sub-Committee of the United States Senate that WaMu's "technology was antiquated" and that the Bank "was on an explosive growth path with a very weak infrastructure." (*Id.* at ¶ 6.) The Complaint recites facts that Rotella admitted in an email that because of the Bank's poor ability to assess its risks and predict losses, "decisions are too heavily based on what has happened

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versus what may." (*Id.* at ¶ 104.) In addition, the Complaint alleges that Schneider admitted "he, Killinger, and Rotella were too concerned with '[m]arket share and growth focus at the expense of building solid infrastructure and controls.'" (*Id.* at ¶ 135.) Thus, the Complaint repeatedly alleges facts that the Defendants employed a decision-making process that was based on inadequate information to measure and assess the risks of the Higher Risk Lending Strategy.

The Complaint also refers to a number of contemporaneous warnings that the Defendants received regarding the Bank's lack of risk management personnel, processes and technology that made it impossible for them to even measure or control the risks of the Higher Risk Lending Strategy. For example, the Complaint alleges that:

- "They cautioned Killinger and Rotella that '[c]ontinuous review and pro-active credit risk management is a must. This includes having strong portfolio surveillance procedures within business units, consistent credit policies, and ongoing procedures for management oversight and governance . . . .'" (Compl. ¶ 29);
- "They warned that . . . 'we still have gaps relative to competitors in the technologies, people and processes that let them effectively measure and manage credit loss exposures.'" (*Id.* at ¶ 30);
- [The Chief Enterprise Risk Officer warned that:] "We still need to . . . improve our pricing models . . . and improve our modeling capability." (*Id.* at ¶ 34);
- "WaMu's Credit Officer . . . warned that the Bank's businesses were moving so fast that the Bank could not 'catch up and quantify the risk.'" (*Id.* at ¶ 39).
- "The Bank . . . had multiple loan origination platforms that were not coordinated. By the mid-2000s, WaMu still had numerous separate platforms for its SFR [single family residential] lending, with largely manual rather than computerized processes. This lack of integration made it extremely difficult for the Bank to closely track results and manage lending risks in its HFI [held-for-investment] portfolio, which was further exacerbated when WaMu cut staff in order to save costs." (*Id.* at ¶ 101).
- "The Defendants claimed to be 'pricing for the risks' that WaMu was taking with its HFI home loans portfolio, but in fact the Bank could not accurately price for these risks." (*Id.* at ¶ 103).
- "Even as of May 2008, one of the Home Loans Division's top analysts reported that the Bank was unable to 'completely, accurately and

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> efficiently capture, analyze, model and report on key risk and loss drivers across all asset classes.'" (*Id.* at ¶ 106).

The Defendants assert that these warnings are evidence that they made "informed" decisions. However, the allegations create the exact opposite inference, which must be accepted as true under Rule 12(b)(6). Allegations that the Defendants received these warnings demonstrate that the Bank could not accurately track or predict the performance or default rate of the higher risk loans it was making. Thus the Complaint alleges that the Defendants lacked necessary information to reasonably assess the risks involved in the Higher Risk Lending Strategy, yet they chose to move forward anyway. By any measure, this is not the kind of informed decision-making protected by the business judgment rule. *Cf. Stahl*, 89 F.3d at 1517 ("A d[i]rector cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment."). Indeed, one of the fundamental duties of a bank officer or director is to ensure that the bank properly manages its risks and engages in safe and sound lending activities. Defendants failed to live up to this basic standard of due care and therefore cannot insulate their decisions under the business judgment rule.

b. The Defendants Refused to Give Risk Managers Any Real Input Into Their Decisions.

The Complaint contains additional allegations that support the FDIC's claims that the Defendants' decision-making process was flawed. The Complaint alleges that the Defendants purposely excluded risk managers from having a meaningful voice in their decision-making process. The Complaint also articulates repeated instances where the Defendants marginalized the risk management function of the Bank precisely at the time when the Bank's riskier home lending demanded more robust risk management. (*See, e.g.*, Compl. ¶¶ 90-98.)

Indeed, while Defendants argue that they were engaging in "risk-return decision-making" of a kind protected by the business judgment rule, the facts alleged in the Complaint tell a completely different story. For example, the Complaint alleges facts that WaMu's Chief Enterprise Risk Officer gave Killinger a memorandum just weeks before the Bank was closed

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advising him that "the Bank lacked the basic internal processes to make well-considered decisions in which the risks and benefits of each course of action were properly weighed." (Compl. ¶ 97.) The allegations continue:

> Even at that late date, WaMu not only had serious deficiencies in its capacity to gather, report and analyze data needed to make good decisions, it lacked a culture that valued such an approach to decision-making. He wrote: 'As a result, neither ERM nor other WaMu employees seem to have unifying principles to effectively reflect a risk management perspective in important decisions or day-to-day activities.' As he put it, the Bank's 'DNA' was missing 'the risk chromosome.'

(*Id.*) The Complaint further alleges that risk managers' "[p]roposals were made and ignored," that they "were not given a meaningful voice and in many cases [were] treated with disdain," (*id.* at ¶ 94), that the "Defendants knowingly suppressed discussions of SFR lending risk in meetings of the Executive Committee," (*id.* at ¶ 95), and that the "Defendants created and fostered a culture in which a risk management perspective was largely absent or ignored." (*Id.* at ¶ 98.) These allegations comprise the core of the Complaint and support the FDIC's assertion that the Defendants' decision-making process was flawed and thus their conduct is outside the protection of the business judgment rule. Taking large and unprecedented lending risks while marginalizing risk management is not a defensible business judgment.

The Complaint also alleges that the Defendants decentralized the risk management function of the Bank and subordinated risk management personnel to the business lines to reduce their power and influence over the Defendants' decisions. The Complaint alleges that:

> Beginning in late 2005, Rotella spearheaded structural changes that diminished the authority and independence of Enterprise Risk Management ('ERM'), the central risk management group at the Bank. Primary credit risk responsibility was placed in the profit-oriented business lines . . . ERM became more of an advisory group rather than an effective watchdog over the Home Loans Division, and there was no truly independent risk management group with authority to manage the risks of SFR lending.

(Compl. ¶ 92.) The Complaint continues, alleging that, "[i]n approximately August 2005, Defendants hired a Chief Risk Officer for the Home Loans Division, with little background in risk management and none at a Bank." (*Id.* at ¶ 93.) Thus, the Complaint is replete with

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allegations that the Defendants deliberately weakened the Bank's central risk management function, showed disdain for professional risk managers, and ignored the warnings they did receive, rather than properly considering them when making their decisions. Again, these allegations demonstrate a lack of reasonable decision-making, which is a threshold requirement for the operation of the business judgment rule in Washington.[8]

c. Despite Knowing of the Housing Bubble, Defendants Based Their High Risk Lending Strategy on Sustained Growth in Home Prices But Created No Exit Plan to Mitigate Future Losses.

Another significant flaw in the Defendants' decision-making process was their failure to create and implement an exit strategy that would prevent or mitigate losses from the inevitable bursting of the housing bubble. The Complaint alleges that, "Defendants knowingly pushed their Higher Risk Lending Strategy at a point in the housing cycle when prices were unsustainably high. . . . Defendants thus gambled billions of dollars of WaMu's money on the prospect that the Bank somehow would manage to avoid losses on higher risk loans to high-risk borrowers in high-risk areas, despite their own awareness of the inevitable decline in the overheated housing market."[9] (Compl. ¶ 5.) The Complaint further alleges that the Defendants "knew that the substantial, short-term gains generated by this lending strategy would only continue if real estate prices remained inflated. Once the 'housing bubble' burst, . . . WaMu would incur substantial losses because the collateral for the loans would no longer be sufficient to pay off the underlying loans." (*Id.* at ¶ 7.) Thus, the Complaint alleges:

> With proper attention to risk management, Defendants could have aborted or at least tempered the Higher Risk Lending Strategy, and improved the

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[8] The FDIC's Complaint also alleges that the Defendants did not act with complete candor when informing WaMu's Board about the risks of their proposed strategy or the Bank's ability to monitor those risks, which further removes their conduct from the protection of the business judgment rule. "Although Defendants repeatedly assured WaMu's Board that they were properly managing and pricing for the risks associated with the Higher Risk Lending Strategy for the residential loan portfolio, it was not true." (Compl. ¶ 9.)

[9] As examples of the Defendants' knowledge of the housing bubble, the Complaint alleges that in June 2005, Killinger acknowledged, "We are currently experiencing the most speculative housing market we have seen in many decades," (Compl. ¶ 40), and by June 2006, he admitted, "We expect the housing market to be weak for quite some time as we unwind the speculative bubble." (*Id.* at ¶ 53.)

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> risk management infrastructure for making and holding high risk loans. Had they done this, WaMu would have been better prepared for the inevitable decline in the housing market, and would have avoided or at least significantly mitigated the substantial losses that the Bank ultimately suffered.

(*Id.* at ¶ 9.) The Defendants' complete abdication of their responsibility to plan for the bursting of the housing bubble — an event that Killinger openly predicted — is another example of their lack of due care that precludes reliance on the business judgment rule.

In sum, the FDIC's Complaint focuses not only on the disastrous results of the Defendants' gross mismanagement, but also on the Defendants' negligent decision-making process itself. Killinger concedes in his motion that a director or officer "who has wholly abdicated his corporate responsibility, closing his or her eyes to corporate affairs," is not entitled to the protection of the business judgment rule. (Killinger Mot. at 7 (citing *FDIC v. Castetter*, 184 F.3d 1040, 1046 (9th Cir. 1999).) This is precisely what the FDIC alleges the Defendants did in WaMu. The Defendants caused the Bank to take extreme risks by moving forward with the Higher Risk Lending Strategy in the absence of adequate technology and personnel while recklessly impeding efforts to effectively assess and manage those risks. The Defendants' muted the voice of risk management, arrogantly referring to them as "checkers checking checkers," (Compl. ¶ 94), and failed to fully inform themselves about the risks that the Bank was taking. (*See* Killinger Mot. at 6 ("a 'failure to adequately investigate' would remove an officer or director 'from the rule's insulating effect'") (citing *Riss*, 934 P.2d at 681).) If the Defendants had supported robust risk management, the Bank could have mitigated the risks and lessened fatal losses from its high risk lending. Instead, the Defendants chose to layer risk on top of risk in WaMu's home loans portfolio without any idea how many losses these loans would cause. The business judgment rule does not protect this type of conduct. Accordingly, the Defendants' motions to dismiss should be denied.[10]

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[10] Washington law only requires a showing of simple negligence to demonstrate a lack of due care in the decision-making process and overcome the business judgment rule. However, the facts plead in the FDIC's Complaint also are sufficient to establish grossly negligent and reckless behavior as well.

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C. Defendants' Proximate Cause Argument Is Legally Incorrect and Cannot Be Resolved on a Rule 12(b)(6) Motion.

Defendants Rotella and Schneider assert that the FDIC has not plausibly pled proximate causation. This assertion lacks merit. First, the Defendants improperly rely on allegations made by the FDIC in other proceedings — the so-called Appraisal Vendor Complaints — as dispositive evidence in this case. As discussed below, allegations in another case are not judicial admissions in a different case. Second, the Defendants' argument fails because it ignores well-settled precedent that more than one proximate cause of a loss legally can and often does exist. Such an occurrence is not fatal to the FDIC's claims. Third, the scope of allegations and damages in the Appraisal Vendor Complaints is far narrower than in those alleged in the present Complaint and thus do not preclude recovery. Therefore, the Defendants' proximate cause argument should be rejected.

1. The FDIC's Allegations in the Appraisal Cases Are Not Binding Judicial Admissions In This Case and Cannot Form a Basis for Dismissal.

The FDIC's allegations in the Appraisal Vendor Complaints are irrelevant to whether the Complaint in this case states a plausible negligence claim. Contrary to Defendants' contentions, courts in the Ninth Circuit repeatedly have held that allegations in one case are *not* binding judicial admissions in a different case. *See, e.g., Am. Passage Media Corp. v. Cass Comm., Inc.*, 750 F.2d 1470, 1473 n.2 (9th Cir. 1985) (holding that allegations from a complaint filed in one action were "admissible evidence but not conclusive admissions" in a second action) (citing 4 WIGMORE, EVIDENCE § 1066); *Grove Lumber & Bldg. Supply, Inc. v. Argonaut Ins. Co.*, No. SA CV 07-1396 AHS, 2008 WL 2705169, at *5 (C.D. Cal. July 7, 2008) ("a statement made in one lawsuit cannot be a judicial admission in another") (quoting *Kohler v. Leslie Hindman, Inc.*, 80 F.3d 1181, 1185 (7th Cir. 1996)); *Migliori v. Boeing N. Am., Inc.*, 97 F. Supp. 2d 1001, 1009 n.9 (C.D. Cal. 2000) ("pleadings from a prior litigation . . . are not judicial admissions binding upon the litigants in a different litigation") (citing 31 M. GRAHAM, FEDERAL PRACTICE AND PROCEDURE: *Evidence* § 6726 (interim ed.1997)). Thus, the allegations contained in the Appraisal Vendor Complaints might be admissible evidence at a trial on the merits of this case, but they

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cannot form the basis for a motion to dismiss because "weighing of the evidence is inappropriate on a [Rule] 12(b)(6) motion." *Jones v. Johnson*, 781 F.2d 769, 772 n.1 (9th Cir. 1986).

Defendants' cited cases on judicial admission are inapposite. In *Hakopian v. Mukasey*, 551 F.3d 843, 846-47 (9th Cir. 2008), the judicial admission was made in pleadings in the *same case*, not in a separate action. Moreover, in that case the government *agreed* with the immigration plaintiff's allegation that he had entered the United States on a certain date. *Id.* In the instant case, the Defendants presumably will *not* agree that they proximately caused the harm to the Bank, so the allegation will be contested. Where allegations are contested, there is no binding admission even in the same case. *See Cortez-Pineda v. Holder*, 610 F.3d 1118, 1122 (9th Cir. 2010) ("*Hakopian* did not establish a blanket rule that facts alleged in a [pleading], if admitted before the [court], bind the court and the parties. . . . We made explicitly clear in *Hakopian* that an entry date alleged in a Notice to Appear might not bind the [immigration judge] if . . . the entry date is *subsequently contested*") (emphasis added).[11] Defendants' other cited cases similarly are distinguishable because they involved internally contradictory materials within the *same case*, and not different cases. *See Reddy v. Litton Indus., Inc.*, 912 F.2d 291, 296-97 (9th Cir. 1990) (amendment of complaint would be futile because it would directly contradict the factual allegations of prior complaint in the same case); *Am. W. Airlines, Inc. v. GPA Group, Ltd.*, 877 F.2d 793, 801 (9th Cir. 1989) (amendment of complaint would futile because it would contradict sworn affidavits in the same case); *Minnick v. Clearwire US, LLC*, 683 F. Supp. 2d 1179, 1188 (W.D. Wash. 2010) (documents incorporated by reference in the same case undermined the allegations of the complaint).

Defendants also cite to *Walaschek & Associates, Inc. v. Crow*, 733 F.2d 51, 54 (7th Cir. 1984), where the Seventh Circuit stated that, "the pleading in one proceeding is admissible and cognizable as an admission in another." But subsequent cases in that circuit have clarified that

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[11] Moreover, allegations in the same case can be amended or explained before they are found to be binding on the party making them. *See, e.g.*, *Sicor Ltd. v. Cetus Corp*., 51 F.3d 848, 859-60 (9th Cir. 1995) ("where … the party making an ostensible judicial admission explains the error in a subsequent pleading or by amendment, the trial court must accord the explanation due weight").

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Walaschek was referring to *evidentiary* admissions, not binding judicial admissions: "While *Walaschek* stands for the proposition that the pleadings in one case may be admitted as substantive evidence in another, it does not hold that such evidence must be given controlling or conclusive weight." *Woolard v. Woolard*, No. 05-c-7280, 2007 WL 2789097, at *5 (N.D. Ill. Sept. 19, 2007) (citing *Enquip, Inc. v. Smith-McDonald Corp*., 655 F.2d 115, 118 (7th Cir.1981)). Indeed, in an opinion issued a dozen years after *Walaschek*, the Seventh Circuit clarified that, "a statement made in one lawsuit cannot be a judicial admission in another. It can be evidence in the other lawsuit, but no more." *Kohler*, 80 F.3d at 1185 (original emphasis, citations omitted).

Lastly, Rotella and Schneider's argument rests on the erroneous premise that the facts alleged in the Appraisal Vendor Complaints must be taken *as true* for purposes of this case. But that simply is not the law under the judicial notice doctrine. *See Metro. Creditors' Trust v. PriceWaterhouseCoopers, LLP*, 463 F.Supp.2d 1193, 1198 (E.D. Wash. 2006) (while a court may take judicial notice of the existence of complaints in other actions, "[t]he Court ***may not, however, accept any of the allegations of these complaints as true***") (emphasis added). Indeed, even "taking judicial notice of *findings of fact* from another case exceeds the limits of Rule 201," let alone mere allegations. *See Wyatt v. Terhune*, 315 F.3d 1108, 1114 (9th Cir. 2003) (emphasis added); *see also M/V Am. Queen v. San Diego Marine Constr. Corp*. 708 F.2d 1483, 1491 (9th Cir. 1983) ("As a general rule, a court may not take judicial notice of proceedings or records in another cause so as to supply, without formal introduction of evidence, facts essential to support a contention in a cause then before it.") (citing 29 Am. Jur. 2d Evidence § 58 (1967)).

In sum, Rotella and Schneider misstate the law regarding judicial notice and judicial admissions. Because their proximate cause argument rests on these erroneous legal assumptions, their argument must be rejected.

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2. Washington Case Law Is Well-Settled That More Than One Proximate Cause Can Exist for the Same Injury.

The Defendants' proximate cause argument also must fail because the law recognizes that multiple proximate causes can exist for the same injury. There is nothing contradictory about the FDIC alleging such concurrent causes of loss in different actions against different defendants.

At the pleading stage, the FDIC need only plead that Defendants' acts and omissions, "in a direct sequence unbroken by any new *independent* cause, produce[d] the injury complained of, and without which such injury would not have happened." *Fisher v. Parkview Props., Inc.,* 859 P.2d 77, 82 (Wash. Ct. App. 1993) (emphasis added).[12] "[T]he concurrent negligence of a third party does not break the chain of causation between original negligence and the injury." *Travis v. Bohannon*, 115 P.3d 342, 348 (Wash. Ct. App. 2005). "If the defendant's original negligence continues and contributes to the injury, the intervening negligence of another is an additional cause. It is not a superseding cause and does not relieve the defendant of liability." *Id.* (citation omitted). In pointing to the Appraisal Vendor Complaints, Defendants completely disregard the well-settled rule that "there may be more than one proximate cause of an injury." *Id.* at, 348 ((citing *State v. Jacobsen*, 442 P.2d 629, 630 (Wash. 1968)); *see* RESTATEMENT (SECOND) OF TORTS § 439 ("If the effects of the actor's negligent conduct actively and continuously operate to bring about harm to another, the fact that the active and substantially simultaneous operation of the effects of a third person's innocent, tortious, or criminal act is also a substantial factor in bringing about the harm does not protect the actor from liability . . . ."). The cases cited in Defendants' brief acknowledge this precedent. *See, e.g., In re Sunrise Sec. Litig.*, 138 F.R.D. 60, 62 (E.D. Pa. 1991) ("In order to prove its negligence claims . . . the FDIC must demonstrate first that the defendants were negligent and second that such negligence was ***a*** proximate cause of the losses sustained.") (emphasis added) (cited in Rotella & Schneider's Mot. to Dismiss at 13-14).

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[12] The FDIC's Complaint here clearly alleges proximate cause. For example: "Had the Defendants fulfilled the duties they owed to WaMu and acted with the requisite level of care, the Bank would not have had a large volume of multi-risk layered loans in its HFI portfolio. Defendants' conduct caused the Bank to lose billions of dollars on these high-risk loans." (Compl. ¶ 180; *see also id.* at ¶¶ 175-179, 186, 191.)

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Nowhere in the Complaint does the FDIC allege that the Defendants' conduct was the *sole* proximate cause of WaMu's losses. For example, the Complaint alleges that, "[a]s ***a*** direct and proximate result of Defendants' negligence, the FDIC as Receiver for WaMu, suffered damages …" (Compl. ¶ 191 (emphasis added)), and that "[e]ach of the Defendants played ***a*** crucial role in the ill-fated Higher Risk Lending Strategy." (*Id*. at ¶ 119 (emphasis added).) At no point does the Complaint exclude the possibility of other factors contributing to the loss. *See, e.g.*, *Metro. Mortgage & Sec. Co., Inc. v. PriceWaterhouseCoopers, LLP*, No. CV-05-290-FVS, 2005 WL 3501873, at *6 (E.D. Wash. Dec. 21, 2005) (denying outside auditor's argument that professional negligence claim should be dismissed for lack of proximate cause due to the plaintiff's own lack of internal controls; "[p]laintiffs do not allege that deficiencies in their internal controls and accounting systems were the ***sole*** cause of Plaintiffs' damages") (emphasis added).

Defendants make conclusory accusations that the negligence of the Appraisal Vendors constitutes a "superseding cause" that would absolve Defendants of their liability. But the question of whether the conduct of the Appraisal Vendors was a superseding cause or a concurrent one is a question of fact, not appropriate for resolution at this early stage of the litigation. *See Travis*, 115 P.3d at 348 ("The issue of proximate cause . . . is usually a question for the trier of fact. Specifically, Washington courts have consistently held that it is for the jury to determine whether the act of a third party is a superseding cause or simply a concurring one.") (citing *Levea v. G.A. Gray Corp.*, 562 P.2d 1276 (Wash. Ct. App. 1977); *Eckerson v. Ford's Prairie Sch. Dist. No. 11*, 101 P.2d 345, 350 (Wash. 1940)); *Metro. Mortgage*, 2005 WL 3501873, at *6 ("Whether Plaintiffs can ultimately establish proximate cause is an issue of fact not ripe for resolution in a motion to dismiss.").[13] In deciding the Defendants' Rule 12(b)(6)

[13] Even when the question of proximate cause comes before the finder of fact in this case, Defendants will not be able to escape liability. Courts have found bank directors to be a proximate cause of losses brought on by imprudent loans even though the directors argued that other factors, such as a poor economy, were the proximate cause of the loss. *See, e.g.*, *FDIC v. Bierman*, 2 F.3d 1424, 1434 (7th Cir. 1993) ("The appellants' contention that the poor farm economy in Indiana at the time of the transactions was the proximate cause of the subsequent losses must also fail. Such an argument ignores the point that a proximate cause need not be the only cause; it need only be a substantial factor leading to the injury, not the sole factor.").

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motions, all pleaded facts and reasonable inferences must be construed in the FDIC's favor. *Fayer*, 2011 WL 1663595, at *2.

Lastly, the Defendants cite *Churchill v. Barach*, 863 F. Supp. 1266, 1276-77 (D. Nev. 1994), as a case in which the court dismissed one claim because of inconsistent allegations made by the plaintiff in a prior lawsuit regarding the proximate cause of her injury. (Rotella & Schneider's Mot. at 14-15). This assertion mischaracterizes the facts and holding of that case. In *Churchill*, an airline ticket agent sued a customer for tortious interference with her employment relationship because the customer had sent a letter to the airline complaining about her inappropriate behavior. *Churchill*, 863 F. Supp. at 1268-69. The customer moved to dismiss that claim on the basis that she had alleged in another lawsuit that the airline had terminated her due to age discrimination. *Id.* at 1276. In response to that argument, the plaintiff *admitted* that her tortious interference claim against the customer was based on the customer's letter being "utilized by Continental as part of their calculated scheme to acquire evidence and data to terminate Plaintiff as a pretext for unlawful discrimination on the basis of her age." *Id.* Because the plaintiff had *admitted* that that her only theory of causation was the airline's age discrimination, the court held that she could not maintain her tortious interference claim against the customer. *Id.* In the present case, the FDIC has made no such admission. Rather, it is the FDIC's position, supported by the case law cited above, that the defendants in both suits may be the concurrent cause of the losses at issue to the extent there is overlap between them.

3. The Appraisal Vendor Complaints Cover a Different Time Frame and Smaller Number of Loans Than the FDIC's Allegations Against the Defendants In This Case.

Even if Defendants' contentions regarding superseding cause were correct — which they are not — the negligence counts could not be dismissed because the scope of the FDIC's Complaint in this case is vastly different than that of the Appraisal Vendor Complaints. The FDIC's Complaint here alleges that Defendants' negligence caused billions of dollars in losses from thousands of loans the Bank originated between September 2005 and September 2008. (Compl. ¶¶ 178-180.) In sharp contrast, the two Appraisal Vendor Complaints allege,

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respectively, about $129 million in losses from 194 specific loans and another $154.5 million from 220 specific loans. (EA Compl. ¶ 31; LSI Compl. ¶ 30.)[14] Moreover, while the negligent acts alleged in the Appraisal Vender Complaints all occurred between July 2006 and November 2007 (EA Compl. ¶ 26; LSI Compl. ¶ 28), the alleged wrongdoing in the Complaint here began as early as June 2004 and continued through at least May 2008, with loan losses continuing through the time the Bank was closed on September 25, 2008 (*see, e.g.*, FDIC Compl. ¶¶ 22, 97, 178).[15] Accordingly, because the scope of the negligence claims here are much broader than in the Vendor Appraisal Complaints, they cannot be dismissed.

To avoid this result, Rotella and Schneider speculate that "once the FDIC analyzes the remaining 259,741 eAppraiseIT appraisals and the 385,708 LSI appraisals, it will likely seek billions of dollars in damages." (Rotella and Schneider Mot. at 9.) Nowhere do the Appraisal Vendor Complaints allege that the FDIC will engage in an in-depth analysis of *every* appraisal made by these two companies. Rather, those complaints make clear that "the FDIC and its experts have reviewed in depth only 259" of eAppraiseIT's appraisals and "only 292" of LSI's appraisals. (EA Compl. ¶ 31; LSI Compl. ¶ 30.) Defendants cannot rely on their own speculation to create a proximate cause issue when one simply does not exist.

For all of these reasons, Defendants Rotella and Schneider's motion to dismiss the FDIC's Complaint based on proximate cause should be denied.

D. The Fiduciary Duty Claim Should Not Be Dismissed As Duplicative.

The Defendants argue in their respective motions to dismiss that Count III of the Complaint for breach of fiduciary duty should be dismissed as duplicative of the negligence claims in Counts I and II. However, it would be premature for the Court to dismiss the breach of fiduciary duty claim at this stage of the litigation. The negligence and breach of fiduciary duty claims are intended to be pled in the alternative. As such, there is no danger of prejudice to Defendants by allowing both claims to proceed, since the Complaint does not seek a double

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[14] Attached as Ex. A and Ex. B to Rotella & Schneider's Mot. to Dismiss.

[15] Defendants Rotella and Schneider's alleged wrongdoing began soon after they started to work for WaMu in January and August 2005, respectively.

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recovery. The Court will be in a better position to sort through the claims after more evidence has been gathered. The standards for pleading in the alternative are liberal. *See, e.g.*, *Molsbergen v. U.S.*, 757 F.2d 1016, 1019 (9th Cir. 1985) (referring to the "liberal pleading policy embodied in Rule 8(e)(2)"). Thus, as this Court has done before, it should deny the motion to dismiss because both claims are viable on their face. *See Grassmueck*, 281 F. Supp. 2d at 1232–33 (denying a motion to dismiss "negligent or bad faith performance of duties and breach of fiduciary duty under Washington law" because sufficient facts were pleaded for both claims) (Pechman, J.).

Additionally, the Defendants significantly overstate the authority in favor of dismissal of claims with overlapping elements. Many of the cases cited by the Defendants relied on *state* procedural law for dismissal, without articulating the more liberal federal notice pleading standards. *See, e.g.*, *Hua v. Boeing*, No. C08-0010RSL, 2009 WL 1044587, at *5 (W.D. Wash. Apr. 17, 2009) (applying Washington law on summary judgment motion); *Jacobson v. Wash. State Univ.*, No. CV-05-0092-FVS, 2007 WL 26765, at *11 (E.D. Wash. Jan. 3, 2007) (same); *CMMF, LLC v. J.P. Morgan Inv. Mgmt. Inc.*, 915 N.Y.S.2d (N.Y. App. Div. 2010). Rule 8(e)(2)'s liberal notice pleading standard governs this case. *See Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1102 (9th Cir. 2003) ("The Federal Rules of Civil Procedure apply irrespective of the source of subject matter jurisdiction, and irrespective of whether the substantive law at issue is state or federal."). Defendants' other cited cases involved dismissal of claims on the ground that the claims were not viable as pled. *See Swartz v. KPMG, LLC*, 476 F.3d 756 (9th Cir. 2007) (per curiam); *Resolution Trust Corp. v. Vanderweele*, 833 F. Supp. 1383 (N.D. Ind. 1993); *FDIC v. Gonzalez-Gorrondona*, 833 F. Supp. 1545 (S.D. Fla. 1993).[16]

The District Court for the Western District of Washington has frequently cautioned against prematurely dismissing similar claims. In *Hayton Farms Inc. v. Pro-Fac Corp. Inc.*,

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[16] In fact, some of Defendants' cited cases illustrate that courts can contemplate both claims at the same time. *See, e.g.*, *Grassmueck*, 281 F. Supp. 2d at 1232–33 (denying a motion to dismiss "negligent or bad faith performance of duties and breach of fiduciary duty under Washington law"); *FDIC v. Appling*, 992 F.2d 1109 (10th Cir. 1993) (trial court allowed negligence and breach of fiduciary duty claims to proceed to trial).

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No. C10-520-RSM, 2010 WL 5174349 (W.D. Wash. Dec. 14, 2010), the Court denied a motion to dismiss negligence and breach of fiduciary duty claims while recognizing that they relied on similar facts. Having found that the plaintiffs had done enough to establish a negligence or breach of fiduciary duty claim, the court denied the motion to dismiss on both claims. *Id.* at *9. Other courts in this District have ruled in a similar fashion in other recent cases. *See, e.g.*, *Sadler v. State Farm Mut. Auto. Ins. Co.*, No. C07-995Z, 2007 WL 2778257, at *2-3 (W.D. Wash. Sep. 20, 2007) ("Although plaintiff's [negligence and breach of fiduciary duty] claims might eventually prove duplicative, the Court cannot at this stage of the proceedings find them redundant."); *Minvielle v. Smile Seattle Invest., LLC*, No. C08-910Z, 2008 WL 4962694, at *4 (W.D. Wash. Nov. 19, 2008) (denying motion to dismiss because defendant could cite "no authority for the proposition that plaintiffs must elect between their [allegedly duplicative] claims"). Given this persuasive authority and the lack of prejudice toward the Defendants, the Court should deny the motion to dismiss Count III.

E. The Fraudulent Conveyance and Asset Freeze Claims Against Kerry and Linda Killinger and Stephen Rotella Should Not Be Dismissed.[17]

1. Because the Negligence and Fiduciary Duty Counts State Valid Claims Against Defendants, the Fraudulent Transfer and Asset Freeze Counts Should Not Be Dismissed.

Kerry and Linda Killinger and Stephen Rotella all argue that the fraudulent conveyance and asset freeze claims in Counts IV through VI of the FDIC's Complaint should be dismissed because the FDIC has not adequately pled the underlying negligence and breach of fiduciary

[17] Defendant Esther Rotella has brought a separate motion to dismiss the fraudulent transfer and asset freeze claims against her. The FDIC will respond to her motion separately because it also involves a personal jurisdiction argument not raised by any of the other Defendants and the FDIC has requested an extension of time to respond to her motion until after it receives adequate answers to its pending jurisdictional discovery. To the extent that her motion to dismiss simply incorporates arguments raised by her husband's motion to dismiss, those arguments have no merit for much the same reasons raised discussed by the FDIC in response to Stephen Rotella's motion. According to the Complaint, Esther Rotella was complicit in her husband's transfer of their Orient, New York, real estate into two trusts to avoid the reach of creditors. She also is liable for her husband's monetary transfers regardless of her intent because she was an initial transferee of those fraudulent transfers. *See Thompson v. Hanson*, 239 P.3d 537, 541 (Wash. 2010) (en banc) (discussing RCW 19.40.081(b)(1)). The FDIC will more fully address all of Esther Rotella's dismissal arguments at the appropriate time.

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duty claims in Counts I through III. However, as explained above, the FDIC has adequately pled its claims in Count I through III; thus, this argument must be rejected.

2. The Complaint Adequately Pleads that Stephen Rotella Engaged in Fraudulent Transfers in Excess of $1 Million Based on Rotella's Representations to the FDIC.

Stephen Rotella asserts that the FDIC has not adequately pled specific allegations regarding his alleged transfer of "in excess of one million dollars to Esther Rotella after WaMu failed in September 2008." (Compl. ¶ 205.) This argument is disingenuous. It was Stephen Rotella, through counsel, who provided specific information about these monetary transfers in response to an FDIC asset subpoena. In that response, Defendant Rotella detailed the following transfers:

> Electronic transfers from Stephen Rotella's Schwab account to Esther Rotella's Schwab account: 6/23/2009: $158,000 to Esther's Schwab account; 12/17/2009: $1,200,000 to Esther's Schwab account (to purchase Belle Haven Managed Bond Portfolio).

If Defendant Rotella insists that these allegations be included in the Complaint, the FDIC respectfully requests leave to amend its Complaint to include them.

3. The Complaint Adequately Pleads Facts That Stephen Rotella Fraudulently Transferred His New York Property.

Stephen Rotella attacks the specificity of the FDIC's pleading with respect to his alleged fraudulent transfer of real estate to an irrevocable trust to bring it outside the reach of creditors. More specifically, Rotella claims that the FDIC has not adequately pled facts to show his actual intent to defraud creditors or why he reasonably should have believed that he would incur debts beyond his ability to pay as they became due (to show constructive fraud). (Compl. ¶¶ 206-207.) Rotella acknowledges the FDIC's allegation that he "had been personally named as a defendant in numerous lawsuits at the time of these transfers, which posed a potential exposure far in excess of his means," (*id.* at ¶¶ 206(a), 207), but Rotella argues that the FDIC failed to allege how these suits posed a risk to his personal assets when WaMu purportedly had "$250 million in insurance coverage and an obligation . . . to indemnify him in connection with the lawsuits." Rotella's Mot. at 19. However, it is not the FDIC's burden when pleading a fraudulent conveyance claim to anticipate every possible source of revenue that Rotella might use to fund

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his defense or any settlements or judgments. Moreover, Rule 9(b) explicitly allows "intent" to be pleaded generally rather than with specificity. *See* Fed. R. Civ. P. 9(b) ("Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally."); *see also Valvanis v. Milgroom*, 529 F. Supp. 2d 1190, 1198 (D. Hawaii 2007) ("Plaintiffs' general averment that Milgroom transferred the property with actual intent is sufficient for Rule 9(b)."); *Burnett v. Rowzee*, No. SA CV 07-641DOCANX, 2007 WL 2735682, at *11 (C.D. Cal. Aug. 28, 2007) (holding in context of fraudulent conveyance claim that actual intent to hinder, delay or defraud "may be averred generally pursuant to Rule 9(b)").

In any event, the FDIC's Complaint does more than simply allege actual intent. The Complaint sets forth facts that at the time of the transfers, Rotella was a named defendant in numerous law suits which posed potential exposure far in excess of his means.[18] Rotella is a sophisticated banker who knew or should have known that the $250 million of insurance funds could be depleted by the various lawsuits pending against WaMu's directors and officers at the time of his real estate transfer. Moreover, Rotella could not reasonably have relied on indemnification from WaMu's holding company, Washington Mutual, Inc. ("WMI") because he was being accused of bad faith conduct that often is not indemnifiable. Rotella also knew or should have known at the time of the real estate transfer that if the Bank went into receivership, WMI likely would file for bankruptcy because the Bank was by far its single largest asset; this also would have placed his right to indemnification at risk. In short, Stephen Rotella's claim that he had no incentive in April 2008 to fraudulently transfer his real estate assets is belied by both common sense and the FDIC's allegations in its Complaint, with all reasonable inferences decided in the FDIC's favor. The FDIC's allegations against Rotella satisfy Rule 9(b).[19]

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[18] Indeed, the proposed class-wide *settlement* of the WaMu MDL action is for $105 million, not including the tens of millions of dollars in insurance that already has been depleted for defense costs to date.

[19] However, if the Court believes that additional allegations are necessary, the FDIC is prepared to plead them and requests leave to do so.

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III. CONCLUSION

For all of the foregoing reasons, the FDIC respectfully requests that this Court deny Defendants Kerry and Linda Killinger, Stephen Rotella and David Schneider's motions to dismiss in their entirety. Alternatively, if the Court determines that any portion of the FDIC's Complaint has not been sufficiently pled under the applicable federal notice pleading standards, then the FDIC requests leave to replead any such allegations.

Dated: August 22, 2011.

Respectfully submitted,

FEDERAL DEPOSIT INSURANCE CORPORATION, as Receiver for WASHINGTON MUTUAL BANK,
Plaintiff

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CERTIFICATE OF SERVICE

I hereby certify that on August 22, 2011, the foregoing was electronically filed with the Clerk of the Court using the CM/ECF system which will send notification of such filing to all counsel of record who receive CM/ECF notification, and that the remaining parties shall be served in accordance with the Federal Rules of Civil Procedure.

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